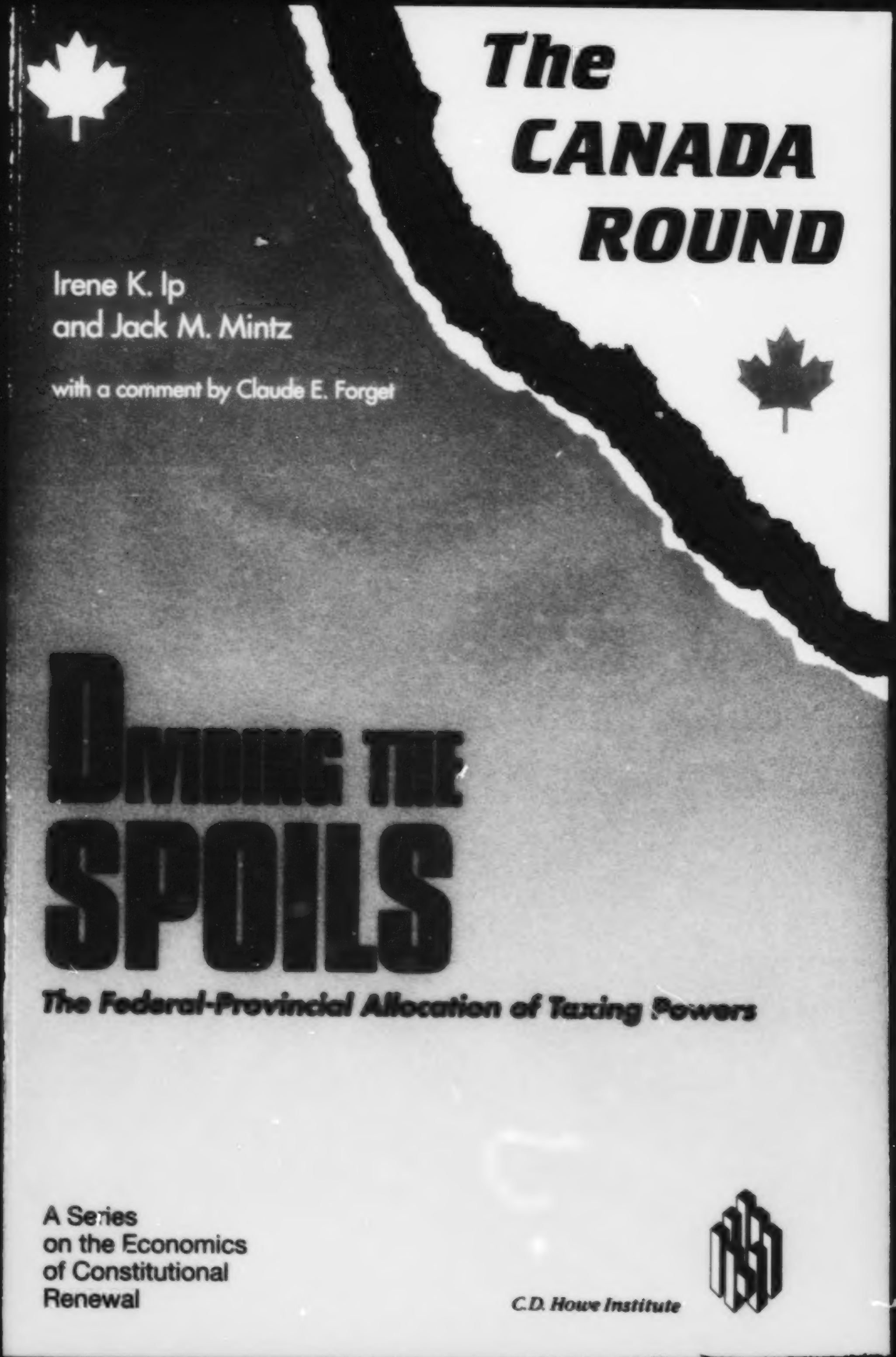

# The CANADA ROUND

Irene K. Ip
and Jack M. Mintz

with a comment by Claude E. Forget

# DIVIDING THE SPOILS

## *The Federal-Provincial Allocation of Taxing Powers*

A Series
on the Economics
of Constitutional
Renewal

*C.D. Howe Institute*

# C.D. Howe Institute

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*C.D. Howe Institute*
*125 Adelaide Street East*
*Toronto, Ontario*
*M5C 1L7*
*(tel.: 416-865-1904; fax: 416-865-1866)*

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*and Jack M. Mintz*

*with a comment by*
*Claude E. Forget*

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A Series on the Economics of
Constitutional Renewal — No. 11

John McCallum, Series Editor

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# Contents

*Foreword* . . . . . . . . . . vii

*The Study in Brief* . . . . . . . . . . ix

*Acknowledgments* . . . . . . . . . . xi

*Dividing the Spoils: The Federal-Provincial Allocation of Taxing Powers,*
by *Irene K. Ip and Jack M. Mintz*

*Introduction* . . . . . . . . . . 3

*Chapter 1:*
*Criteria for Taxing Powers* . . . . . . . . . . 5

*Chapter 2:*
*Historical Background* . . . . . . . . . . 14
From Confederation to the End of the Nineteenth Century . . . . . . . . . . 14
From 1900 to the Outbreak of World War II . . . . . . . . . . 15
From World War II to the Tax Collection Agreements . . . . . . . . . . 17
From the OPEC Crisis to the Present Constitutional Turning Point . . . . . . . . . . 18

*Chapter 3:*
*The Present Structure of the Tax System* . . . . . . . . . . 22
The Constitutional and Administrative Division of Taxing Powers . . . . . . . . . . 22
The National Picture . . . . . . . . . . 23
Provincial Variations . . . . . . . . . . 25
The Overall Tax System . . . . . . . . . . 28

*Chapter 4:*
*The Personal Income Tax* . . . . . . . . . . 34
Structure . . . . . . . . . . 34

Efficiency .....36
Simplicity .....42
Flexibility .....45
Accountability .....46
Equity .....47
The Future of the Tax Collection Agreements .....51
Recommendations .....55

*Chapter 5:*
*Payroll Taxes* .....58
Structure .....58
Efficiency .....60
Simplicity .....61
Accountability .....62
Equity .....63
Recommendations .....64

*Chapter 6:*
*Corporate Income and Related Taxes on Business Capital* .....65
Structure .....65
Efficiency .....70
Simplicity .....75
Flexibility .....76
Recommendations .....78

*Chapter 7:*
*Taxes on Natural Resources* .....81
Structure .....81
Efficiency .....83
Simplicity .....85
Recommendations .....86

*Chapter 8:*
*Taxes on Consumption* .....87
General Sales Taxes .....88
  Structure .....88
  Efficiency .....90
  Simplicity .....96
  Accountability .....98

Equity ....................98
Recommendations ....................100
Taxes on Liquor, Tobacco, and Motive Fuels ....................101
Structure ....................101
Efficiency ....................103
Simplicity ....................110
Accountability ....................110
Equity ....................112
Recommendations ....................112

*Chapter 9:*
*Other Taxes* ....................114
Real Property Taxes ....................114
Structure ....................114
Simplicity ....................115
Efficiency ....................115
Miscellaneous Taxes ....................116

*Chapter 10:*
*Recommendations* ....................119
Conclusion ....................125

***A Comment,***
by *Claude E. Forget* ....................127

***The Contributors*** ....................131

***Members of the C.D. Howe Institute*** ....................133

# Foreword

Canada appears poised to embark on an historic political reconfiguration. It is essential that this process be undertaken with a clear and widely diffused understanding of the well-spring of Canadians' economic prosperity.

It is with that in mind that the C.D. Howe Institute presents this series of monographs entitled *The Canada Round*. The series assembles the work of many of Canada's leading economic and political analysts. The monographs are organized into two groups. The first group, called "The Economics of Constitutional Renewal," rests on the assumption of renewed federalism and is organized around economic themes. It examines the economic goals that Canadians have set for themselves, as well as the means of achieving them and the influence of alternative constitutional structures.

The second group of studies, called "The Economics of the Breakup of Confederation," examines the economic consequences of Quebec independence for both Quebec and the rest of Canada. A unique feature of the "Breakup" studies is that they are integrated with the research that has already been carried out by Quebec's Bélanger-Campeau Commission. Where appropriate, each of the studies in this group includes a summary of the relevant analysis by the Bélanger-Campeau Commission, contributions by experts from across Canada, as well as shorter critiques or replies. This format, we believe, will help to pierce Canada's "several solitudes" and create a pan-Canadian meeting of minds.

*The Canada Round* is not intended to alarm or frighten — the process of collective political definition in this country will turn on more than simply questions of dollars and cents. And, as these monographs will reveal, economics rarely produces an open-and-shut case as to the superiority of one possible set of rules over another. Even if it could do this, it would be unwise to assume that economic analysis alone could change the minds of those who are already committed to a particular vision of the political future.

It is equally clear, however, that Canadians are now seeking a greater understanding of the links between the economy, the Constitution, and legal and political life. A significant reform of the Constitution will influence the economy, in some cases for the better; a rending of the Constitution under conditions of acrimony will almost certainly damage it. Thus, the purpose of the series is to help Canadians think constructively about the benefits and costs of alternative constitutional designs.

Underlying the series is a focus on the economic well-being of Canadians, now and in the future. To best insure this well-being over the short run, Canada needs calm, open negotiations in which efforts are made to understand and incorporate the aspirations of all the participants. This series of monographs is dedicated to that effort.

John McCallum, the series editor and Chairman of the Department of Economics at McGill University, organized the intellectual input. Within the C.D. Howe Institute, David Brown, Senior Policy Analyst, played a coordinating role. This eleventh monograph in the series was copy edited by Darlene Zeleney and Barry A. Norris, and desktop published by Brenda Palmer. As with all C.D. Howe Institute publications, the analysis and views presented here are the responsibility of the authors and do not necessarily reflect the opinions of the Institute's members or Board of Directors.

Thomas E. Kierans
President and
Chief Executive Officer

# The Study in Brief

The federal-provincial division of taxing powers is an important but hitherto largely neglected subject in Canada's current constitutional debate. This study by Irene Ip and Jack Mintz ends that neglect by providing a comprehensive analysis leading to concrete proposals for the rationalization and improvement of our tax system.

The authors analyze each of Canada's major taxes according to five criteria: efficiency, simplicity, flexibility, accountability, and equity. Considerations of efficiency and simplicity will generally favor assignment of the more lucrative tax fields to the federal government. Revenue deficiencies at the provincial level can then be dealt with through transfers from the federal government to the provinces. On the other hand, the flexibility criterion suggests that tax and expenditure powers may be complementary, while the accountability criterion implies that intergovernmental transfers should not be too large and that a change in the division of spending powers should be accompanied by a matching change in the division of taxing powers. Hence the division of powers to spend and to tax cannot be considered in isolation from each other. Ip and Mintz turn next to a brief history of the evolution of the tax system since Confederation, and to a summary of the system's present structure. The system clearly needs improvement according to at least four of the authors' criteria: efficiency, simplicity, flexibility, and accountability.*

Following a comprehensive tax-by-tax analysis, Ip and Mintz arrive at radical recommendations for tax reform. These can usefully be stated in two parts. First, taxes on corporate income and capital should become exclusively federal, while excise taxes and duties on alcohol, tobacco, and gasoline should become exclusively provincial. Under specific assumptions, this federal-provincial "swap" of taxation powers is approximately revenue neutral for the federal government, but not for all provinces.

---

* On equity, matters are less clear, since there is little consensus among governments as to how the principle should be put into practice.

The second part of the authors' recommendations is based on the assumption of a substantial devolution of expenditure powers to the provinces. In their example, Ip and Mintz assume an end to federal financing of health care, postsecondary education, social services, and housing, as well as the transfer of the financing and operation of the unemployment insurance system to the provinces. At the same time, they propose, the federal government should transfer its goods and services tax room to the provinces.

Taken as a whole, the two components of the package come close to leaving federal government revenue unchanged, although on average the poorer provinces would be major losers. Ip and Mintz acknowledge that the formula for equalization payments would have to undergo radical change for their package to be workable.

In summarizing the benefits of their proposals, Ip and Mintz argue that:

> the rationalization of the tax system along the lines that we have suggested would help to strengthen the economic union by minimizing opportunities for...interprovincial barriers to...mobility....It would also provide a greater stimulus to rid the system of the most damaging differentials with the United States, thus enhancing our international competitiveness. Other important benefits would include the reduction in overall administrative costs, which would help in deficit reduction, and in compliance costs, which would further increase the overall efficiency of the economy. Finally, there would be an increase in accountability and transparency, which are important elements in a well-functioning democracy.

While not disagreeing with the substance of the authors' proposals, Claude Forget, in a brief comment, emphasizes the strength of the bureaucratic resistance that will stand in the way of implementation. Moreover, he argues, governments historically have shown considerable success in avoiding the intent of tax rules.

John McCallum
Series Editor

# Acknowledgments

We would like to thank the following for providing data: the Federal-Provincial Relations and Social Policy Branch of the federal Department of Finance; the Income and Expenditure Accounts Division of Statistics Canada; the Liquor Control Board of Ontario; Société des alcools du Québec; and the Public Relations Department of Imperial Tobacco Ltd. We would also like to thank Duan Jie for providing research assistance, and Darlene Zeleney for her skillful editing.

Irene K. Ip
and Jack M. Mintz,
Toronto, April 1992

# *Dividing the Spoils:*
## *The Federal-Provincial Allocation of Taxing Powers*

# Introduction

In September 1991, the federal government released its proposals for constitutional reform in Canada. As part of its "economic union" package, the government recommended several far-reaching constitutional provisions that would promote the free flow of capital, labor, goods, and services in Canada. In addition, several of the federal proposals involved turning certain powers over to the provinces with the objective of improving efficiency by reducing the overlap and duplication that arise from shared federal-provincial responsibility.[1]

The federal proposals make reference to expenditure programs and regulation, but say little about the allocation of taxation powers. The lack of analysis in this area is a glaring omission in the current constitutional debate. Most reports on constitutional reform, including the federal proposals, either fail to mention taxes or simply suggest that there will be continued co-occupation of tax fields.

This omission is quite startling to us, especially since the federal government has recognized the importance of tax issues in the context of Canada's competitiveness.[2] After all, tax policies affect the flow of capital, labor, and goods in an economic union —in some situations, more than expenditure powers and regulations do — and the federal-provincial co-occupation of tax fields results in duplication and overlap just as in the case of other shared-cost powers.

The purpose of this monograph is to try to raise the profile of tax issues in the current constitutional debate. We outline various criteria for the allocation of taxation authority (Chapter 1) and provide a historical overview of the division of taxation powers in the federal-provincial context (Chapter 2). Then, in Chapter 3, we examine the current allocation of taxation authority and tax revenues. Chapters 4 through 9 offer analyses of the full range of specific taxes within the current tax system, focusing on the ability of each to fulfill its defined objectives. In Chapter 10, we suggest how tax authority could be reallocated to improve the efficiency, flexibility, and accountability of the current tax system.

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[1] For example, the provinces would acquire sole responsibility for manpower training, forestry, mining, recreation, housing, and municipal/urban affairs.

[2] Canada, *Prosperity through Competitiveness* (Ottawa: Supply and Services Canada, 1991), p. 20.

With regard to suggested reforms, we argue that the federal government should have control over corporate tax fields, primarily for reasons of efficiency, and the provinces over sales and excise taxes, primarily for flexibility. The personal income tax field should be co-occupied. We calculate the impact of these tax changes, as well as of a suggested reallocation of expenditure authority, on the budgetary position of each province and of the federal government.

# Chapter 1

# *Criteria for Allocating Tax Powers*

What criteria should guide governments in allocating taxing powers in a federal state? Below, we briefly review five of them: efficiency, simplicity, flexibility, accountability, and equity.[1]

## *Efficiency*

Taxes should have a minimal impact on the allocation of resources in the economy; in other words, they should be levied in an efficient manner. In the private sector, prices of goods and services act as signals for the allocation of resources. Taxes that affect relative prices can distort these signals and thereby distort resource allocation, as exemplified in the levying of the federal goods and services tax on clothes but not food.

In a federal state, governments at the central, regional, and local levels collect taxes and sometimes co-occupy the same field. In principle, efficiency requires that taxes be levied in a manner that affects trade and factor flows across provinces as little as possible. This enhances the gains arising from an economic union among provinces. Two tax arrangements can minimize the distorting effect of taxes described above: (1) uniform rates of tax imposed on activities across jurisdictions, preventing distortion of trade and factors flows, or (2) taxes imposed on activities that are fixed in supply or that are related to the public benefits received by resident taxpayers.

---

[1] A fuller discussion of these criteria may be found in Jack M. Mintz, "The 1991 Federal Budget, Tax Policy and the Constitutional Crisis," in Martin F.J. Prachowny and Douglas D. Purvis, eds., *The February 1991 Federal Budget* (Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, 1991), pp. 46–55; and Jack M. Mintz and Thomas A. Wilson, "The Allocation of Tax Authority in the Canadian Federation," in Robin W. Boadway, Thomas J. Courchene, and Douglas D. Purvis, eds., *Economic Dimensions of Constitutional Change*, vol. 1 (Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, 1991), pp. 169–188. Similar criteria are presented in Canada, Department of Finance, *Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements*, (Ottawa, June 1991).

Efficiency requires not only that governments rely on the kinds of taxes that do not affect the relative prices of goods and services, but also that they impose an appropriate *rate of tax*, since it is the rate of tax that determines the relative prices of public versus private goods and services. The correct "tax prices" must be chosen to insure a balance between the public and private sectors: if, for example, the "tax price" for public goods is too low, the public sector may become too large. A central issue in fiscal federalism is that the "tax price" be chosen correctly by sovereign governments. This requires provinces to coordinate their tax policies to achieve the best possible allocation of public and private resources.

When governments tax goods and services in an uncoordinated manner, *spillovers* — that is, the beneficial or harmful effects on one jurisdiction of the tax policies of another — are induced. An example of a beneficial spillover is a tax-induced "flight" of capital or labor from one jurisdiction to another; it occurs when a government that decides to tax mobile resources does not take into account the consequent benefit of increased resources to another jurisdiction. Conversely, an example of a harmful spillover is *tax exportation* — the situation wherein a regional or local government's taxes are paid by a nonresident, who does not benefit from the public services provided by that tax authority.

When tax policies are uncoordinated — or, as sometimes referred to, "competitive" — governments may choose tax rates that are too high or too low relative to those they would choose in a situation of coordinated policies. The jurisdiction that receives beneficial spillover effects from another government's policies will set its tax rates too low, and vice versa.

## *Simplicity*

A good tax system is simple for the public to understand and easy for the government to administer. The criterion of simplicity can also be taken to mean that governments should rely on as few taxes as possible, and particularly on those that are broadly based, to reduce their own administrative costs as well as the private sector's compliance costs.

In a federal state, the number of different taxes that must be administered by each level of government depends on the number of distinct tax authorities occupying the same tax base. Unless governments agree (1) to collect the tax jointly or (2) to allocate tax bases to different authorities, the duplication and overlap of taxes will make the tax system more costly to operate.

We note the criticism expressed in the Allaire and Bélanger-Campeau reports of the duplication and overlap of federal and provincial spending powers. The same criticism applies to overlapping co-occupied tax bases and uncoordinated tax systems.

## *Flexibility*

Governments have access to a basket of policy tools for accomplishing various objectives. These tools include regulations, expenditure programs, taxes, and subsidies. The optimal policy tool is the one that offers the greatest benefits and involves the lowest costs of implementation — particularly of administration and compliance. Flexibility allows governments to choose the most desirable policy instrument. A good example of flexibility is the ability to achieve redistribution of income through direct expenditures or taxes within the same fiscal system.

Many advocate the use of a negative income tax to provide a guaranteed income[2] — an approach that illustrates how the personal income tax can be used as a flexible tool for providing relief to low-income earners. Instead of employing a system of universal grants, governments can provide a guaranteed income through refundable tax credits. By taxing back the credit — or making it "vanish" — as a person or family earns more income, governments can ensure that the system accurately targets the needy. The system's virtue lies in its similarity to a "means-tested" welfare grant that provides relief to households earning income below a certain level.[3] Means testing, however, is not only more complicated to administer, but can also be embarrassing to potential recipients, who must be interviewed to determine their income level. Because of the latter problem, politicians have tended to prefer universal-grant programs over means-testing programs.

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[2] See Canada, Royal Commission on the Economic Union and Development Prospects for Canada, *Report*, vol. 3 (Ottawa: Supply and Services, Canada, 1985).

It should be noted, however, that expenditure grants can be more flexible than taxes in cases where assistance is being targeted for special purposes. For example, the provision of assistance for specific research and development projects might be easier to implement with the help of scientific authorities, since tax authorities are not qualified to judge the merits of an R&D project. Similarly, regulations such as pollution controls may be more effective than pollution taxes if regulators have difficulty in determining the level of tax necessary to curb pollution.

In the Canadian federation, different areas of expenditure authority are allocated to the federal government and the provincial governments. The federal government is responsible for defense, foreign affairs, equalization of provincial tax capacities, and banking regulation, while the provinces are responsible for property rights, health, welfare, and education. Many areas are, in a sense, co-occupied — for example, the federal government has used its spending power to provide conditional assistance to the provinces in certain areas such as health, transportation, education, and welfare, despite the fact that the constitutional division of power resides with the provinces in these areas.

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[3] For a comparison of the two approaches, see Richard Van Loon, "Comment," in Jack M. Mintz and John Whalley, eds., *The Economic Impacts of Tax Reform*, (Toronto: Canadian Tax Foundation, 1989), pp. 78–82. Van Loon argues in favor of universal grants paid monthly, maintaining that it is difficult to pay income tax credits on monthly a basis. In recent years, however, the federal government has made an effort to pay tax credits — such as the refundable child tax credit — on a more timely basis, and in 1993 will move to a monthly child tax benefit.

For administrative reasons, it is wise to allocate complementary tax authority to the level of government that is responsible for a certain service. Thus, if a particular level of government is responsible for health expenditures, it should also have authority over excise taxes that curb activities that contribute to ill health. Similarly, the level of government responsible for welfare may also wish to have some control over the personal income tax base in order to provide welfare to low-income groups.

## *Accountability*

Accountability is especially important in a federal system, where tax and expenditure assignments at the different levels of government can result in a mismatch of revenue-raising capabilities and expenditure responsibilities. Taxes tend to be assigned to the central government, while expenditures are often assigned to regional governments. When there is a vertical imbalance of this sort, as there is in Canada, intergovernmental transfers are required to transfer tax revenues from the central authority to regional authorities.

Intergovernmental transfers enable regional governments to fund expenditures that they could not otherwise afford, given the limits of the tax revenues they are empowered to collect. As a result, a regional government funds services that benefit residents of its own jurisdiction out of tax revenues collected within *and outside* its jurisdiction. Thus, the "tax price" of public expenditure is distorted, since, for the regional authority, the marginal benefit of expenditure is greater than the cost of raising funds. In addition, since the benefits of federal transfers to the provinces are not transparent to the voter, it is possible that the central government derives less political benefit from, and therefore has less incentive to spend money on, intergovernmental transfers than on other, more transparent, expenditure programs. Such factors contribute to perpetuating the imbalance of revenues and expenditures in a federal system.[4]

Accountability requires that the government choosing to expend funds be responsible to its taxpaying public. A distinction can be made between total and marginal accountability: total accountability requires revenues to be equal to expenditures at each level of government; marginal accountability requires a government to increase revenue when it plans to increase its expenditures.[5] For example, marginal accountability would hold in the case of the federal government giving a block grant that did not vary with the expenditure plans of the provincial government. If the provincial government wished to spend more funds, it would have to raise its own taxes.

Except in a few instances, marginal accountability to a certain extent typifies the current system of intergovernmental grants. Established Programs Financing exemplifies marginal accountability, since these grants for health and education are largely unrelated to the expenditures of the provincial governments. In the Canada Assistance Program (CAP), by contrast, the federal government shares 50 percent of the approved expenditure plans of the provinces. The 1990 federal budget, however, introduced caps on increases in federal funding for the three wealthiest provinces — Ontario, British Columbia, and Alberta — thereby converting the CAP into a system of block-type grants for these provinces. Federal grants given to equalize tax capacities across provinces are also unrelated to provincial expenditure plans.[6]

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[4] We note the current acrimony between the federal and provincial governments over intergovernmental transfers. Given the current federal fiscal deficit, expenditure cuts or tax increases are called for; the easiest course is for the federal government to reduce intergovernmental transfers.

[5] Mintz and Wilson, "Allocation of Tax Authority."

[6] As we shall discuss later, qualifying provinces receive an equalization payment when their tax capacity is below a certain norm. Although the amount of the equalization payment they receive cannot be influenced by expenditures, their tax capacity can be affected by government policies. For example, a province can reduce its tax capacity by nationalizing companies that would otherwise pay corporate income tax.

## *Equity*

Good tax policy is concerned with equity — that is, fairness. Fairness is achieved when the tax system affects similar households in similar ways (horizontal equity) or recognizes that different households have different capacities to pay (vertical equity). Governments redistribute income through expenditure (transfer) programs and the tax system. The most important tax used in Canada to accomplish vertical-equity objectives has been the personal income tax.

In a federal state, a difficult philosophical question arises: Should equity in the tax system be determined at the national level or at the provincial level? This is not a question that we can answer. On the basis of national citizenship, one could argue in favor of national redistribution policies that use the same rules for all citizens, no matter where they reside. In more decentralized systems that assume that citizens of a province should determine redistribution, however, equity is defined at the provincial level. Vertical and horizontal equity could not be achieved at the national level unless the provinces chose uniform tax rates, uniform tax bases, and a mix of taxes.

As noted above, Canadian provinces are constitutionally granted the power to provide welfare. In fact, all provinces have their own welfare programs, with some financial assistance provided by the federal government through the CAP and other transfer programs. The personal income tax field has been co-occupied with the federal government: all provinces except Quebec allow the federal government to collect provincial personal taxes, which must conform with the federal base.[7] It is clear, therefore, that equity objectives in Canada have been defined at both the federal and provincial levels and that the power to determine redistribution is currently shared.

Although there is no clear normative case for equity to be assigned at the federal or provincial level, it may be that only the joint occupation of redistributive programs is *practical*, for a number of reasons. Even if one takes the view that equity should be defined at the provincial, not the national, level, it may be practical for the provinces to entrust to the federal government powers over redistributive policies. This is so because individual provinces cannot achieve redistributive goals on their own without attracting low-income residents and discouraging high-income households from residing in the jurisdiction.[8] The degree of mobility in a federal state depends on cultural attachment to a region: the stronger the attachment, the less mobile the population and the greater the region's ability to redistribute income. (This is an important principle to keep in mind. The francophone population in Quebec is less sensitive to economic differentials than the anglophone population throughout the rest of Canada. Quebec is therefore better able than the other provinces to pursue independent redistributive policies.)[9]

---

[7] We discuss these points in greater detail later on. It should be noted here that provincial variations currently exist in tax surcharges, credits, flat taxes, and low-income-relief provisions.

## *Summary*

The allocation of tax authority is guided by five principles: efficiency, simplicity, flexibility, accountability, and equity. In some cases, these principles are in conflict with one another — for example, greater equity can often be achieved only by sacrificing simplicity. The first two principles suggest that taxes may be allocated without regard to the allocation of expenditure powers. The importance of spillovers and simplicity would argue for the federal government's being given major control over many of the more lucrative tax fields in Canada, particularly income, payroll, and capital taxes. This would lead to a vertical imbalance, which could be eliminated by intergovernmental transfers to the provinces. However, if the provinces were to become responsible for most of the expenditures undertaken by governments in Canada, the size of such transfers might become very large. This would conflict with the principles of flexibility and accountability.

---

[8] This illustrates another spillover, such as those discussed above with respect to efficiency.

[9] Quebec not only collects its own income tax, but, as discussed below, the deductions and credits it gives for low-income relief vary considerably from those provided by other provinces.

The third, fourth, and fifth principles suggest that the allocation of taxing powers should take into account the distribution of expenditure powers at the federal and provincial levels. Tax powers should be assigned to complement a government's expenditure powers. Also, the government should be made accountable for its expenditure plans — the latter option requires a matching of expenditures and taxes at each level of government, and minimizes intergovernmental transfers.

In our view, one cannot take an extreme position in favor of any particular principle. Each should be given consideration in designating tax authority in Canada. If constitutional reform calls for a greater allocation of expenditure powers to the provinces, however, intergovernmental transfers will become too large under present tax-sharing arrangements. Those arrangements will then have to be rethought.

# Chapter 2

# *Historical Background*

## From Confederation to the End of the Nineteenth Century

When the Fathers of Confederation were allocating taxing powers, they were concerned that the provinces should not impose taxes on economic activity beyond their boundaries and that their taxes should not interfere with interprovincial trade. These criteria remain valid today. Before Confederation, the main source of colonial revenue was the tariff, while municipalities relied on the property tax and, in Ontario, on the income tax. The *British North America Act* (section 92a) denied provinces the use of "hidden" taxes, which meant they had to give up both import and excise duties,[1] but allowed them unfettered use of politically unpopular direct (income) taxes.[2] Because the founding fathers intended the central government to be responsible for the most costly programs, it followed that they should allocate to it the greatest degree of fiscal power. The federal government was therefore given access to all tax sources. Giving up the lucrative tariff, however, left the new provinces with insufficient revenue to finance spending responsibilities that had been accorded to them. The gap had to be filled by federal transfers to the provinces.

---

[1] Excise duties had been in existence since 1846 (Statistics Canada, *Canadian Economic Observer*, October 1989, p. 3.2).

[2] As economists note today, direct taxes, such as corporate income and capital asset taxes, are similar to indirect taxes, such as payroll and excise taxes, in that, in theory, corporate taxes are also shifted onto the consumer, or onto factor incomes accruing to labor, land, and capital.

It is important to recognize how quickly these early revenue arrangements encountered opposition. Before six years had elapsed, the federal government was handing out "special" grants to certain provinces to settle various problems, including the threat of Nova Scotia's departure in 1869. The geographical expansion of the federation created additional strains on fiscal resources.

During the remainder of the century, an international depression caused financial distress at both levels of government. The federal government refused to expand its subsidies, which led the provinces to turn to new direct sources of revenue. British Columbia introduced a personal income tax and a land tax in 1876, Quebec led the way for the other provinces in levying a charge on places of business and business capital in the 1880s, and Ontario passed a succession duty law in 1892, which the other provinces quickly copied. As it turned out, these taxes were more important as precedent revenue raisers.[3]

## From 1900 to the Outbreak of World War II

After 1900, Canada witnessed several major social and economic developments, including large-scale immigration, industrial development, and rapid urbanization. With subsequent interpretations of the *British North America Act*, an imbalance was created whereby, in the first four decades of this century, provincial spending responsibilities exceeded provincial tax revenues. With growing regional disparities, World War I, and a depression in the 1930s, changes in circumstances made it difficult to reallocate powers through constitutional amendments. This vividly illustrates the dangers to Canada of having a rigid and inflexible separation of spending and taxing powers.

When the federal government introduced excise taxes in 1915, it continued a convention of sticking to indirect (commodity) taxes and leaving the direct (income) taxes to the provinces. This division of tax fields was contested in 1917, however, when the financing needs of World War I persuaded the federal government to enter the personal income tax (PIT) and corporate income tax (CIT) fields, a move that was "generally challenged as an 'invasion' of provincial taxing powers."[4] At the same time, the federal government strengthened its occupation of the consumption tax field by bringing in a general sales tax in 1920, nearly two decades ahead of the provinces. The so-called manufacturers' sales tax was changed to its final structure in 1924: the tax was applied to manufacturers' sales of qualifying domestic goods and imports.

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[3] A. Milton Moore, J. Harvey Perry, and Donald I. Beach, *The Financing of Canadian Federation* (Toronto: Canadian Tax Foundation, 1966), p. 4.

Meanwhile, provincial governments, faced by expanding demand for infrastructure and services, were looking for ways to increase their revenue growth. One fortuitous development was the advent of the automobile, which opened up two new revenue fields — license fees and gasoline taxes — that could be exploited by the provinces to finance the growing demand for their services. Thus, during the 1920s, all nine provincial governments introduced gasoline taxes, a source that was left exclusively to the provinces until the 1970s. Also in the 1920s, provincial monopolies on the sale of liquor became a major source of revenue.

The Great Depression brought on new fiscal problems. In an effort to balance their rapidly deteriorating budgets, all governments sought new revenue sources — but not with the benefit of federal-provincial coordination. This led to a "tax jungle" of double taxation, duplicate administration, and an escalation in compliance costs, particularly with respect to commodity, corporate income, and personal income taxation.

During this time, Alberta and Saskatchewan entered the sales tax field. To get around the constitutional constraint against indirect taxation by provinces, they levied their sales taxes at the retail level at the time of sale. (Alberta removed its sales tax the following year.)

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[4] Ibid. The income tax was meant to be temporary, but, like most taxes, it became a permanent feature of the tax system.

Seven provinces introduced a CIT, making it universal. Ontario, Quebec, Saskatchewan, and Alberta enacted PIT legislation, bringing to seven the number of provinces that had their own PIT by 1939. This fiscal anarchy was brought to an abrupt end by the exigencies of World War II.

## From World War II to the Tax Collection Agreements

To help defray the costs of World War II, the federal government asked the provinces to temporarily vacate the PIT, CIT, and succession duty fields, providing an opportunity to develop some basic coordination of the tax system after the war. The federal government also entered the field of alcohol taxation in 1942. A relatively minor innovation at the provincial level that would become more of an issue in the 1980s was the introduction of a tax on paid-up corporate capital by Quebec in 1947 and, ten years later, by Ontario.

During World War II, the federal government established the Rowell-Sirois Commission to look into federal-provincial fiscal relations. In view of the state of confusion and duplication in tax fields prior to the war, the commission specifically recommended that:

- there be a clear separation of revenue fields;
- the personal income, corporate income, and estate tax fields be left to the federal government;
- the provinces alone occupy the tax fields left to them and be allowed to collect those taxes by direct or indirect means; and
- unconditional grants be made to the poorer provinces.

After World War II, most provinces permitted the federal government to "rent," for a payment, the personal income, corporate income, and estate tax fields. Only Quebec levied its own PIT (starting in 1954), and Quebec and Ontario levied their own CITs (starting in 1947 and 1957, respectively). In 1962, however, the tax rental agreements were replaced by Tax Collection Agreements, and the federal government gave up sole occupancy of the income tax and estate tax fields. The federal government reduced its tax by lowering rates, thus making room for the provinces to levy their own PIT and CIT rates. Ottawa would collect the taxes on behalf of the provinces, and the provinces would assess a tax based on federal taxes payable (for the PIT) or on taxable income (for the CIT). This arrangement meant that the provinces continued, to a large extent, in their use of the federal tax base.

The Rowell-Sirois report's recommendation that co-occupancy of tax fields be eliminated was clearly moribund by 1962. Provinces had not only rejoined the federal government in levying income and estate taxes, but, with the exception of Alberta, co-occupied the general sales tax field as well — although the federal and provincial taxes were levied at different stages of production. In addition, Quebec maintained its own PIT and Quebec and Ontario continued their own separate CITs after 1962. (In the 1970s, Alberta also adopted its own CIT.)

## From the OPEC Crisis to the Present Constitutional Turning Point

The first oil price shock in the early 1970s ushered in an era of federal-provincial competition for energy revenues. The federal government responded with a "two-price" energy plan, consisting of a subsidy to oil importers and an offsetting charge on oil exporters. Because the subsidy was larger than the export tax revenue, the federal government introduced a gasoline excise tax in 1975. A prolonged tug-of-war between Ottawa and the resource-rich provinces over oil and gas revenues reached its apogee in 1980 with the National Energy Program (NEP), which resulted in a veritable explosion of new energy levies.[5] The battle was eventually won by the provinces in two steps. First, their right to levy indirect taxes on resources was included as part of the *Constitution Act, 1982*. Then, in 1985, after world energy prices had failed to reach even the "worst-case" projections, the NEP, including most special federal government energy taxes, was dismantled. Although Ottawa's two-price energy policy died with the NEP, its excise tax on gasoline survived and a tax on diesel and aviation fuel, other than gasoline, was born. Both of these fuel taxes underwent healthy growth over the rest of the decade — from 1.5 cents to 8.5 cents per liter and from 2 cents to 4 cents per liter, respectively — and now raise a substantial sum: close to $2.5 billion in 1989. Saskatchewan repealed its special tax on motor fuel in 1982, as other revenues from the energy sector burgeoned, but reinstated it in 1987, shortly after Alberta introduced a general fuel tax.

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[5] At one time, energy consumers were paying, directly or indirectly, the Petroleum Compensation Charge, the Petroleum and Gas Revenue Tax, the Natural Gas and Gas Liquids Tax, the Incremental Oil Revenue Tax, the Canadian Ownership Charge, and the tax nicknamed the "Lougheed Levy."

In the 1970s, the federal government undertook a major reform of the income tax system. (Quebec and Ontario introduced similar changes to their CIT systems, as did Quebec to its PIT system.) The first stages of a second tax reform began in 1986, with corporate tax measures being adopted in February 1986; personal income tax reform and additional corporate tax measures followed in 1988.

The provinces, in general, enhanced the revenue from their commodity taxes in the 1970s and 1980s through tax-rate increases and expansion of taxable goods and services, but there were also some notable moves in the opposite direction. Quebec exempted furniture, furnishings, refrigerators and stoves for residential dwellings, and most clothing, footwear, and textiles. Saskatchewan increased the number of exemptions between 1982 and 1987 until most of what was termed "family essentials" had been exempted.[6] The three Maritime provinces and Quebec enacted separate tobacco tax legislation in 1963, and by 1971 all the provinces had introduced a tax on tobacco products. These taxes were, for the most part, in addition to their retail sales taxes (RSTs), as well as to the federal array of levies on tobacco products, making the latter the most heavily taxed commodity in the country.[7]

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[6] Saskatchewan, Budget Address, 1990, p. 26.

From 1973 to 1990, all the other provinces followed Quebec and Ontario in imposing some type of capital tax, while general payroll taxes were introduced by four provinces. Taxes or charges designed to deal with environmental problems have been increasing in the last few years. These include levies on nonreturnable beverage containers (Ontario, Quebec), taxes on new tires (Prince Edward Island, Ontario, British Columbia), a tax on new batteries (British Columbia), and a corporate concentration tax (Ontario).

In a move to shore up revenues, the federal government made its first incursion into the retail sales tax field in 1983 with a tax on telecommunication programming services, which was extended in 1988 to residential long-distance telephone charges. After years of trying to replace its sales tax — uniformly criticized by government, business, and academics — with one that had fewer flaws, Ottawa finally introduced a goods and services tax (GST) — essentially a value-added tax — effective in 1991. With this, it reaffirmed its right to levy a tax at the retail level. Although some provinces have challenged the federal intrusion into this field, the courts have so far recognized the federal government's constitutional right to it. Three provinces — Prince Edward Island, Quebec, and Saskatchewan — announced plans to harmonize their RSTs with the GST, but both Prince Edward Island and Saskatchewan have since backed out. Quebec has delayed full implementation, but even after "harmonization," its tax base would be quite dissimilar to the federal one because of its exemption of intermediate stages of production and certain consumer goods such as books.

From this brief survey of events in the evolution of the Canadian taxation system, the following major conclusions should be kept in mind in looking ahead to new taxing arrangements:

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[7] In 1984, according to estimates by Statistics Canada, the ratio of commodity tax to producer price on tobacco products was about 240 percent, compared with 150 percent on alcoholic beverages and 25 percent on gasoline products (Statistics Canada, *Canadian Economic Observer*, May 1989, p. 3.19).

- No arrangement can ever anticipate all future developments. Neither is it reasonable to expect a single tax structure to be appropriate for all regions. Thus, flexibility is essential.
- No level of government is ever going to be satisfied with the split in shares. However, economic welfare considerations should never take a back seat to political priorities.
- Overlap may not always be a bad thing, as long as the federal and provincial governments can minimize the administrative and efficiency costs of overlap as exemplified by past tax-sharing agreements.

# Chapter 3

# *The Present Structure of the Tax System*

## The Constitutional and Administrative Division of Taxing Powers

The absence of a constitutional constraint on the federal government's taxation rights, while the provincial governments were limited — with the explicit exception of resources — to levying taxes directly on individuals and businesses might have been expected to result in the preemption of many tax sources by the federal government.[1] But, in practice, the provincial sector has been shut out of very few revenue sources. Although the property tax and resource revenue fields are constitutionally accessible to the federal government, the former has traditionally been left to the provincial-local level, and the federal government has been virtually absent from the latter, except for the corporate income tax, since the mid-1980s. The withholding taxes levied on nonresidents and the once-lucrative field of customs duties are the only sources of revenue that are constitutionally closed to the provinces.[2] Federal excise duties that are levied on beer, spirits, and tobacco products are hardly distinguishable in form and objective from federal excise taxes, which are also levied on tobacco products as well as on wine and miscellaneous items. At the provincial level, gallonage charges on alcoholic beverages are almost the same as federal excise duties; Quebec, in fact, levies what it calls an excise duty on alcohol.[3] The extent of federal-provincial tax entanglement can be gauged by the fact that about three-quarters of total tax revenue is raised in fields that are jointly occupied by the federal and most of the provincial governments.[4] Government revenue sources can be divided into about a dozen major categories (see Table 1).[5]

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[1] The Constitution did not permit the provincial governments to levy taxes that could be exported to other provinces. Thus, taxes on intermediate goods (indirect taxation) were not allowed.

[2] Both customs and excise duties were originally in the exclusive jurisdiction of the federal government.

## The National Picture

A simple breakdown of tax occupancy by the federal and provincial/local sectors provides a picture of largely overlapping tax fields. The equality of the two levels of government, however, is evident in the distribution of revenues raised by each level. In 1989, the provincial/local sector was raising slightly more than half of the nation's tax and levy revenue (excluding Canada and Quebec Pension Plan contributions). In the same year, the federal government dominated the personal income tax (PIT), corporate income tax (CIT), and revenues from tobacco and alcohol, while the provincial/local sector took the lion's share of gasoline taxes and general sales taxes — although this latter split has probably become more even with the advent of the federal goods and services tax.

In terms of revenue raised, the PIT and the general sales taxes are the most important sources of revenue for both levels of government. The property tax, however, raises almost as much money for the aggregate provincial/local governments as does the retail sales

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[3] Federal excise duties and taxes are both generally specific rather than *ad valorem* charges. Provinces levy volume charges on sales of alcoholic beverages either in the form of license fees or simply as bottle levies.

[4] Because we have used 1989 data, Table 1 excludes the Large Corporation Tax and finance and insurance capital taxes levied at the federal level. These capital taxes act as minimum taxes and are adjusted for payment of the corporate income surtax with respect to the former and the corporate income tax with respect to the latter. Thus, even the capital tax field is now jointly occupied by the federal and provincial governments.

[5] The equalization formula includes 37 provincial revenue sources alone, but many of these are subcategories.

## Table 1: *Shares of Major Revenue Sources, by Level of Government, 1989*

| Revenue Source | Federal Share | Provincial and Local Share | Total Amount |
|---|---|---|---|
| | *(percent)* | *(percent)* | *($ millions)* |
| Personal income tax[a] | 64 | 36 | 81,632 |
| Payroll taxes and health premiums | 51 | 49 | 20,281 |
| Corporate income tax | 68 | 32 | 16,816 |
| Indirect corporate taxes (including capital taxes) | 0 | 100 | 1,719 |
| Resource royalties and taxes[b] | 0 | 100 | 3,944 |
| General sales taxes | 45 | 55 | 36,776 |
| Excise duties and taxes on alcohol, tobacco, and liquor commission profits | 59 | 41 | 5,761 |
| Customs duties | 100 | 0 | 4,501 |
| Gasoline and fuel taxes | 42 | 58 | 7,658 |
| Miscellaneous excise and indirect taxes | 3 | 97 | 5,812 |
| Property taxes | 0 | 100 | 19,511 |
| Withholding taxes | 100 | 0 | 1,537 |
| Benefit charges and taxes[c] | 100 | 0 | 855 |
| Miscellaneous fees, licenses, government enterprise profits, etc. | 32 | 68 | 9,575 |
| *Total own-source taxes and levies* | *50* | *50* | *216,377* |
| Shared revenues | 58 | 42 | 168,923 |

[a] Adjusted for Quebec abatement.

[b] The federal and provincial/local shares of resource royalties and taxes are not precisely 0 and 100 percent, respectively, but the federal share is insignificant.

[c] Such as Western Grain Stabilization levies.

Sources: Authors' calculations based on data from Canada, Statistics Canada, *Provincial Economic Accounts*; idem, *Financial Management System*; Canada, Department of Finance, unpublished data; and Manitoba, Budget, 1990.

tax (RST). The CIT is a more important source of revenue at the federal level than at the provincial level. Revenues from unemployment insurance premiums (a payroll tax) are also very large. It is worth recalling that, apart from the general taxation of fuel, alcoholic beverages, and tobacco products, considerable sums are collected by both government levels in the form of special taxes and para-taxes on these commodities — for example, excise duties and taxes, licenses, and liquor product markups.[6] Many of these swell the base price on which the general sales taxes are levied.

## Provincial Variations

As Table 2 illustrates, individual provinces' tax structures by no means fit the aggregate pattern. For a start, only in the provinces east of Ontario are the PIT and RST unambiguously the most significant revenue sources. Alberta does not have a general RST, and in the three other Western provinces, the property tax raises more revenue. By contrast, in the five Eastern provinces, and especially in Newfoundland, the property tax accounts for a far smaller share than the national average. Resource revenues are significant only in the West (with the exception of Manitoba). In 1989, even the share of the PIT varied among provinces from 17 percent to 27 percent.

There were some major changes in source dependence over the past decade that were common to a majority of provinces. The PIT share increased in all provinces but Quebec. The revenue from the general retail sales tax and the tobacco tax increased in importance in nine provinces. (It maintained a stable share in Manitoba.) Gasoline tax collections were less significant in all provinces but Quebec, Alberta, and British Columbia. All provinces but Prince Edward Island raised relatively less from both direct and indirect taxes on the corporate sector in 1989 than in 1979. The share of property tax receipts fell in six provinces.[7]

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[6] Statistics Canada does not publish a breakdown of miscellaneous levies on alcohol.

[7] Prince Edward Island, Nova Scotia, Quebec, Ontario, Manitoba, and British Columbia.

## Table 2: *Provincial and Local Government Own-Source Revenue as a Proportion of Total Revenue, 1989*

(Provincial Economic Accounts basis)

| | Nfld. | P.E.I. | N.S. | N.B. | Que.[a] | Ont. | Man.[b] | Sask. | Alta. | B.C. | Terr. | Canada |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | *(percent)* | | | | | |
| Personal income tax | 23.5 | 27.0 | 28.1 | 26.7 | 26.6 | 25.0 | 20.9 | 17.9 | 16.9 | 22.6 | 37.4 | 23.9 |
| Corporate income tax plus other corporate taxes | 3.8 | 4.6 | 4.4 | 4.9 | 4.8 | 7.2 | 6.0 | 4.2 | 6.8 | 4.0 | 6.8 | 5.8 |
| Health and social insurance levies | 2.9 | 1.1 | 2.2 | 2.6 | 12.8 | 8.7 | 5.6 | 1.3 | 4.5 | 6.6 | 7.7 | 8.2 |
| Property taxes | 7.3 | 11.1 | 13.1 | 12.8 | 12.9 | 18.4 | 19.0 | 14.7 | 15.1 | 17.3 | 13.6 | 16.0 |
| Retail sales tax | 33.6 | 30.0 | 25.2 | 28.0 | 16.9 | 19.5 | 16.1 | 12.6 | 1.7 | 15.5 | 4.7 | 16.5 |
| Gasoline tax | 4.7 | 4.6 | 4.4 | 4.8 | 4.2 | 3.5 | 4.1 | 3.0 | 2.4 | 4.0 | 5.5 | 3.7 |
| Royalties plus other resource revenue | 1.4 | 0.0 | 0.1 | 1.6 | 0.4 | 0.4 | 0.7 | 7.5 | 17.4 | 5.9 | 0.4 | 3.2 |
| Interest[c] | 12.0 | 14.3 | 11.0 | 10.7 | 8.4 | 6.6 | 18.1 | 12.7 | 24.9 | 11.7 | 15.3 | 10.6 |
| Miscellaneous revenue[c] | 10.9 | 7.3 | 11.5 | 7.9 | 13.1 | 10.8 | 9.4 | 26.0 | 10.4 | 12.5 | 8.5 | *12.0* |

[a] Personal income tax and transfers adjusted for tax abatement and payroll taxes; payroll taxes are added to health and social insurance levies.

[b] Payroll levy has been excluded from miscellaneous revenue and included in health and social insurance levies.

[c] Includes hospital sector revenue.

Sources: Authors' calculations based on data from Canada, Statistics Canada, *Provincial Economic Accounts*; idem, *Financial Management System*; Canada, Department of Finance, unpublished data; and Manitoba, Budget, 1990.

Although these changes vary significantly in size, the trends they indicate are quite clear. Nationally, there has been a tendency for variations in shares of revenue sources among the provinces to decline, particularly with respect to four major sources — PIT, CIT, property, and gasoline tax. There has also been a convergence in provincial patterns within the Western and Atlantic regions. (An exception was an increase in the range of PIT shares in Atlantic Canada.) For Quebec and Ontario, by contrast, only the PIT shares moved closer to each other, but recent developments will narrow the differences in the shares of payroll and general sales taxes. Other indications of convergence in tax structures is the increasing popularity of capital and payroll taxes.

The convergence of tax shares by province appears to be related to the sensitivity of the tax bases to provincial or foreign competition. For example, the decline in importance of corporate taxes for all governments in Canada from 1965 mirrored a trend among industrialized countries (with the exception of Japan). However, the overall increase in dependence on sales tax revenue by 1989 suggests that there was little concern about crossborder shopping. Provinces also have to take into account the ease with which taxable economic activity can be shifted to another province. The narrowing of the RST range within the Eastern and Western regions suggests some concern about loss of taxable sales to neighboring provinces. By contrast, the widening in the range of PIT dependence among the Atlantic provinces appears to be related to the fact that labor has tended to move out of the region altogether, rather than from province to province; tax differences between the Atlantic provinces and Ontario have a greater impact on labor migration than do tax differences among the provinces within the region. Quebec also had to acknowledge that if it did not lower its generally heavier tax burden (compared with Ontario) for higher-income earners, it risked losing human capital. There are, in fact, more examples of low-rate provinces closing the gap with their higher-rate neighbors than vice versa. For example, in 1987, after a number of years of below-average corporate income tax rates, Prince Edward Island and Alberta raised those rates to the levels that prevailed in the other Atlantic provinces and British Columbia, respectively, and in the 1980s, Ontario raised its PIT rates to bring the tax burden closer to Quebec's. Disparities in the shares of tax sources appear to have been reduced over time as a result of interprovincial competition in some cases and the lack of it in others.

## The Overall Tax System

Although it is important to evaluate individual tax sources according to the often-competing criteria of efficiency, simplicity, flexibility, and accountability, in some respects the whole tax structure as it operates in each province should be taken into account. In fact, with regard to the principle of equity, only the whole fiscal system — taxes and expenditures — is really relevant.

### *Tax Efforts*

In order to compare total tax regimes by provinces, a summary statistic is useful. One that may be used is the Index of Total Tax Effort — the ratio of revenue raised to fiscal capacity. These calculations are carried out by the federal Department of Finance in computing equalization entitlements. There are 37 categories of revenue included in the equalization formula and, for each category and province, the department (1) collects the data of revenue yield, (2) estimates a standardized base — that is, the size of the activity being taxed, for example, retail sales, wage bills — and (3) calculates an effective national tax rate for each category. When the national rate is applied to each individual province's standardized tax base per capita for each category, a fiscal capacity measure is obtained. The tax effort index shows how far the province has gone in exploiting its fiscal capacity relative to the national standard. This index has many flaws. For example, the tax bases exclude nonmonetary benefits that increase people's well-being but are not taxed, such as home ownership or scenic environments. It is also of little help in comparing the fairness of the systems, which can be judged only by taking into account government transfers and benefits in addition to the whole array of taxes.

Comparisons of these indexes for 1989/90, as shown in Table 3, reveal unequal provincial tax efforts. For all taxes and levies that are included in the equalization formula, the range is from 75 (in Alberta) to 110 (in Quebec). The major factor behind the lower efforts in the Atlantic region is the low level of exploitation of the property tax base. (A partial explanation is the difficulty of collecting property taxes in rural communities, especially in Newfoundland.) Even among the Atlantic provinces, however, there is a spread of almost ten points in total tax effort. Among the three "have" provinces (Alberta, British Columbia, and Ontario) the spread is three times larger. Prince Edward Island, Nova Scotia, Alberta, and British Columbia have exploited their fiscal capacity to a lesser degree than the rest of the country. The three provinces with the highest tax efforts were all equalization recipients.

The calculations in Table 3 group similar revenue sources to better evaluate the effort in each field. Although the seven "have-not" (equalization-recipient) provinces used most of the tax fields, on average, more intensively than did the "have" provinces, there is no pattern that fits all the "have-nots" or all the "haves." There are more similarities geographically: Eastern provinces exploit the retail sales tax field more than Western provinces do; Western provinces exploit the property tax and "other" revenues — taxes on insurance premiums, lotteries, and miscellaneous — more. In general, it is simply the pervasive variations that are striking. In fact, in the areas where the most effort at harmonization has occurred — the PIT and CIT — the range is very large: from 86 (in Alberta) to 110 (in Manitoba) for the provinces participating in the PIT collection agreements, and from 94 (in Prince Edward Island) to 532 (in Saskatchewan) for the provinces participating in the CIT collection agreements. The variations in tax effort by province and by tax base reflect both the availability to some provincial governments of windfall revenues from resources — which can lessen the tax burden on personal income, sales, and corporate profits — and the differences

**Table 3:** *Tax Effort by Source and Province, fiscal year 1989/90*[a]

| Source of Tax | Nfld. | P.E.I. | N.S. | N.B. | Que. | Ont. | Man. | Sask. | Alta. | B.C. | "Have-Nots"[b] | "Haves" |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | *(100 = national tax effort)* | | | | | | |
| Personal income tax | 108 | 105 | 99 | 105 | 128[c] | 92 | 107 | 110 | 86 | 87 | 120 | 91 |
| Payroll taxes and health insurance premiums | 0 | 0 | 0 | 0 | 186 | 85 | 93 | 0 | 56 | 105 | 129 | 84 |
| Business income revenue | 98 | 94 | 103 | 101 | 53 | 111 | 116 | 532 | 79 | 98 | 93 | 104 |
| Business income revenue and capital taxes | 77 | 75 | 85 | 95 | 81 | 110 | 132 | 464 | 58 | 77 | 109 | 95 |
| General and miscellaneous sales taxes | 187 | 134 | 117 | 158 | 115 | 115 | 106 | 88 | 1 | 88 | 118 | 90 |
| Fuel taxes and vehicle licenses | 99 | 79 | 83 | 101 | 153 | 91 | 90 | 91 | 54 | 92 | 126 | 84 |
| Tobacco taxes and revenue from alcohol sales | 121 | 127 | 110 | 146 | 87 | 89 | 132 | 143 | 118 | 109 | 104 | 98 |
| Property taxes | 46 | 61 | 78 | 78 | 86 | 120 | 106 | 98 | 82 | 89 | 87 | 108 |
| Resource revenue | 71 | 33 | 46 | 52 | 34 | 91 | 175 | 108 | 99 | 129 | 74 | 105 |
| Other revenue subject to equalization | 93 | 93 | 96 | 73 | 94 | 92 | 123 | 168 | 126 | 99 | 102 | 99 |
| *Total* | *101* | *93* | *92* | *100* | *110* | *102* | *110* | *125* | *75* | *93* | *109* | *95* |

[a] The figures indicating "tax effort" are ratios of the yield of revenues that are subject to equalization as a percentage of the yield of the tax bases at national average tax rates.

[b] The "have-not" provinces are all provinces except Ontario, Alberta, and British Columbia.

[c] Quebec's personal income tax is net of $1,877 million for 16.5 tax abatement points.

Source: Authors' calculations based on unpublished data from Canada, Department of Finance.

in mobility among tax bases. For example, Alberta's tax efforts in the fields of PIT, combined business income revenues and capital taxes, and sales taxes are either the lowest or next to the lowest.

## *Simplicity*

The present tax structure is characterized by a very large variety of tax sources (plus public pension plans) involving three levels of government and joint occupancy in most cases. A modifying influence on this tangled mass is the Tax Collection Agreements (TCAs) for both the personal and corporate income taxes, which have kept administration costs down for these two taxes and made them simpler for taxpayers to understand and comply with. Nevertheless, the entire system costs more than necessary for both administration and compliance.

## *Equity*

Both the federal and provincial governments appear to be more or less in agreement in principle that fairness means "equal treatment of people in similar circumstances" and "that high-income persons and profitable corporations should pay a fair share of tax."[8] There is no consensus among governments, however, on how that principle should be put into practice. Should equity, for example, be measured on an individual, family, or household basis? What is a fair share of tax for high-income people? Both levels of government appear to agree that vertical equity means that the rich should bear proportionately more tax as a share of income and that, with income redistribution, lower-income people should be made relatively better off. In other words, the entire fiscal system should be progressive.[9] There have been, however, many disagreements between some provincial governments and the federal government about how the personal income tax and corporate income tax systems treat high-income classes and high-profit corporations. The big question is: Which level of government best reflects the values and attitudes of the residents of each province?

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[8] David Dodge, "Economic Objectives of Tax Reform," in Jack Mintz and John Whalley, eds., *The Economic Impacts of Tax Reform* (Toronto: Canadian Tax Foundation, 1989), p. 38.

Taken together, public statements made by provincial governments on the subject of fairness in the tax system give a confusing view of whether fairness should be determined nationally or provincially — that is, whether there is a place for interprovincial variations. Interprovincial comparisons of provincial tax burdens are made without taking into account either deficits or the impact of most expenditures on taxpayers' circumstances. And, while it is true that it is virtually impossible to measure satisfactorily the full impact of all government revenues, expenditures, and deficits, comparisons of the burdens of major provincial taxes are nonetheless not very useful for answering questions about equity. Furthermore, provinces that make such comparisons generally employ different bundles of taxes, and so come to different conclusions.[10] When such comparisons are accompanied by statements about fairness, there is an implication that interprovincial equity in the tax system is desirable and relevant. Other statements, by contrast, leave no doubt about the provincial definition of equity. The Quebec government is, perhaps, the best example. It explained its higher tax burden relative to

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[9] Past studies that have examined the overall progressivity of the Canadian tax-expenditure system suggest that the impact of government largesse on income redistribution is roughly neutral. The most important instruments used to redistribute income are the PIT and transfer payments targeted to lower-income individuals. On the pitfalls of measuring the impact of taxation on income distribution, see John Whalley, "Regression or Progression: The Taxing Question of Incidence," (Innis Lecture) *Canadian Journal of Economics* 17 (1984): 654–682.

[10] For example, in 1984, both Saskatchewan and Alberta claimed to have the lowest tax burdens for a four-member family with $15,000 gross income (Saskatchewan, Budget Address, 1984, p. 61; and Alberta, Budget Address, 1984, p. 104). Saskatchewan included such comparisons in its annual budget statements until 1990. Other provinces that have occasionally used them are Manitoba (1991) and British Columbia (1991).

Ontario's by its need to spend more for specific provincial objectives. Saskatchewan has had definite views about equity as perceived by its residents, and New Brunswick has referred to equity in the context of the province's system alone.[11]

Canadian federalism has dealt with the issue of interprovincial equity by entrenching the principle of equalization in the Constitution. To prevent weaker provinces from having to impose an undue burden of taxation on their residents in order to deliver levels of public services comparable to those offered by the stronger provinces, the federal government equalizes their taxing capacity. This means that at least some rough form of interprovincial horizontal equity should be evident across provincial tax systems. As we have seen, however, indexes of tax effort indicate that there is probably a broad range in tax burdens across the country,[12] which suggests that benefits are not similar from province to province in mix and depth and that attitudes about redistribution are not comparable — in other words, that people in different provinces want their provincial governments to supply different levels of services.

The difficulty with provincial rather than national standards of equity is that because some tax bases are mobile and some taxpayers are guilty of "free-riding" — that is, of avoiding paying their full share for benefits — a province that is providing a higher level of public services may run into difficulties in raising the revenue needed to finance them. For such provinces, these pressures are likely to force convergence in tax structures and rates.

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[11] Quebec, *White Paper on the Personal Tax and Transfer Systems: Introductory Paper*, 1984, pp. 7–9, 19, 21; Saskatchewan, *A Dialogue on Saskatchewan Income Tax Reform*, 1988, p. 4; New Brunswick, Budget Address, 1991–92, p. 40.

[12] The problem with using the index of tax effort as an index of tax burdens is that the incidence of the tax may not always coincide with the province that collects it.

# Chapter 4

# *The Personal Income Tax*

With this chapter on the personal income tax (PIT) system, we embark on our tax-by-tax analysis of the current tax system in Canada. Each of Chapters 4 through 9 considers the structure of the particular tax or taxes under discussion, then proceeds to a critique based on the criteria for allocation of taxation authority outlined in Chapter 1.

## Structure

Nine provinces are party to Tax Collection Agreements (TCAs) with the federal government for the PIT. Quebec levies its own PIT. The key components of the TCAs are as follows:

- To arrive at a basic federal tax, the federal government defines the income base, determines what deductions may be made to arrive at net and taxable income, sets the rate structure, and determines the type and value of nonrefundable tax credits.
- The provinces set their tax rate as a percentage of the basic federal tax.
- The federal government collects the provinces' basic tax without charge.
- The federal government agrees to administer, on a cost-recovery basis, a limited number of surtaxes, flat taxes, and tax credits beyond the basic system to compensate for the provinces' loss of flexibility.

The nine "agreement" provinces are free to levy their own PIT at any time, but, in spite of frequent grumbling and threats, none has done so. Perhaps one of the most important reasons for the longevity of the TCAs is that the federal government values them so highly that it has tried to accommodate most of the requests the provinces have made for add-ons to the basic tax structure. Besides low-income tax reductions and surtaxes, all provinces have tax credits, many of which are refundable. Some have a special flat-rate tax on adjusted income.

Another harmonizing feature, which also includes Quebec, is the agreement that the PIT revenue will be directed to the province in which the taxpayer normally resides on December 31. This avoids double taxation of the income earned by individuals who reside or earn income in more than one province.

Even though Quebec does not have a TCA with the federal government, its PIT system is very similar to the federal system. Quebec's definition of assessable income and its treatment of dividends and capital gains are virtually the same as the federal government's. Quebec changed its structure substantially in 1988 to reflect the reformed federal system — in particular, converting most of its exemptions to credits and reducing the number of rate brackets.[1] Nevertheless, there are some significant differences between the Quebec and the federal systems, including the approach to inflation indexation, Quebec's more generous credits for dependants, and its retention of deductions for tuition fees and employment-related expenses — Quebec Pension Plan (QPP) and unemployment insurance (UI) contributions and other employment expenses.[2]

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[1] The number of brackets was reduced from 16 to five, compared with the federal government's three. Quebec has no surtax, however, while the federal government has two.

[2] Quebec has no automatic indexation of tax brackets and credits for inflation, but, since reform, it has fully indexed most of its credits each year. The federal system has automatic indexation of tax brackets and most credits for inflation above 3 percent. (The federal government's conversion of deductions to credits excluded the deduction for employment expenses, which was simply eliminated.)

It is worth pointing out that although we try to make interprovincial comparisons, they are quite complex and not at all straightforward because of the array of tax credits, surtaxes, and flat taxes.

## Efficiency

A strongly harmonized tax system is likely to be simpler to operate and less distortive than separate, uncoordinated tax systems. Strong coordination reduces the opportunities for independent governments to engage in "beggar-thy-neighbor" tax policies to attract resources, a practice that subsequently distorts labor and capital flows, and thereby impedes the potential gains to be had from economic union. (One example is the provision of tax credits or deductions for equity investment in entities that satisfy certain provincial criteria, such as the location of the head office, which impedes the flow of savings across provincial boundaries.) If all provinces introduce such policies, no government wins, while individual provinces end up being less efficient.

At the same time, however, strong harmonization rules out the possibility of provincial experimentation, which could conceivably lead to a more efficient system nationally. Albert Breton has argued that "tax competition [among] the provinces and possibly between the provinces and the federal government" might bring greater benefits than can be derived from the forced harmonization of the TCAs.[3] Such competition would be prompted by taxpayer pressure, as well as by the lessons of experimentation learned by different governments in the federation. Because the federal government is solely responsible for the structure of the PIT system, any efforts it makes at tax reform will always be characterized by caution in terms of the impact of the reform on provincial revenues and tax structure. For example, the 1988 tax reform lowered federal PIT revenues, and subsequently, provincial revenues dropped by a disproportionate amount. The provinces could recoup revenues only by raising PIT statutory rates, thereby offsetting the reduction of federal PIT rates. Indeed, there is often reluctance to innovate at the federal level since the provinces might undo federal initiatives. The existence of 11 independent PIT systems could increase the probability of one government's being willing and able to take such risks; it "could also lead to greater provincial influence on federal tax policies."[4] The Quebec government's actions provide an example of such experimentation.

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[3] Albert Breton, "Supplementary Statement," in Canada, Royal Commission on the Economic Union and Development Prospects for Canada, *Report*, vol. 3 (Ottawa: Supply and Services Canada, 1985), p. 518.

Discussions about the advantages of a harmonized system frequently overlook the fact that the federal government has itself been the source of numerous measures over the years that have distorted the allocation of resources. (The Scientific Research and Cape Breton tax credits are two examples that come readily to mind.) When such measures affect the basic federal tax, as the capital gains exemption does, the provinces participating in TCAs have only limited means to neutralize them.

The provinces frequently complain about lack of flexibility in the TCAs, but what that often means is that they are unable to use the tax system for economic incentives to particular sectors or for activities that they consider to be at an unsatisfactory level. The federal government claims that the TCAs play an important role in discouraging competing provincial tax policies that "inhibit or distort the efficient allocation of capital and labour,"[5] yet some of the add-ons the federal government has agreed to administer within the agreements have had just such an effect. For example, the Saskatchewan government introduced a number of "economic tax credits" in 1984 to encourage provincial residents to invest in targeted provincial industries.[6] By contrast, Ontario's small business development program does not target any particular activity. Eventually, incentives that target particular industries may come under scrutiny by Canada's trading partners, which may limit their use in the future. In the meantime, all forms of beggar-thy-neighbor tax policies need to be discouraged.

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[4] Saskatchewan, *A Dialogue on Saskatchewan Income Tax Reform*, 1988, p. 29.

[5] Canada, Department of Finance, *Personal Income Tax Coordination* (Ottawa, June 1991), p. 5.

[6] The Saskatchewan government's Tax Incentive Program offered venture-capital tax credits to stimulate investment in "small manufacturing, processing, tourism and research and development firms" and a tax credit per head of cattle, hogs, and lambs owned and fed in the province for specified periods (Saskatchewan, Budget Address, 1984, pp. 3–4, 43–45, and Budget Address, 1989, p. 42).

The differentials in provincial income tax rates may also influence people's mobility. The TCA provinces' statutory tax rates vary considerably, especially once the surtaxes in six provinces (eight in 1991) are taken into account (see Table 4). In the latter case, British Columbia, rather than Alberta, has the lowest top marginal rate and Manitoba, rather than Newfoundland, has the highest. Remarks made from time to time by finance ministers and treasurers suggest that the provinces do take the rate structures of other provinces into account before changing their rates, but the type of competition that led to lower rates in Quebec in the 1980s is less evident than a "follow-the-leader-upward" form of competition. For example, New Brunswick's finance minister justified the introduction of an 8 percent surtax for 1991 by noting that it would "move [the province's] top marginal rate in line with other provinces."[7] These differences in marginal tax rates, however, are not a good guide to the effect of the PIT on the migration of population from one jurisdiction to another, although governments often express concern about the negative impact of high marginal tax rates on work incentives and investment decisions. If Manitobans were lured by comparable job opportunities in Ontario, Alberta, or British Columbia on the basis of tax considerations alone, it would more likely be on the basis of average effective rate differentials (to which we turn later). In principle, migration would be influenced not only by the PIT, but also by provincial differences in sales taxes and, perhaps, in property taxes that are not capitalized in the value of land.

Although various assumptions are likely to produce different results because of the variety of tax expenditures that exist in different provinces, it is possible to draw some fairly robust conclusions

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[7] New Brunswick, Budget Address, 1991, p. 37.

## Table 4: *Statutory and Marginal Personal Income Tax Rates by Province, 1990*

| | Nfld. | P.E.I. | N.S. | N.B. | Que. | Ont. | Man. | Sask. | Alta. | B.C. | Federal |
|---|---|---|---|---|---|---|---|---|---|---|---|
| Low-income reduction[a] | no | no | no | no | yes | yes | yes | yes | yes | no | — |
| Surtax rate (%) | — | 10 | 10 | — | — | 10 | 2 | 12 | 8 | — | 5;3 |
| Surtax threshold[b] | — | $12,500 | $10,000 | — | — | $10,000 | [c] | $4,000 | $3,500 | — | $10;$15,000 |
| Provincial rate as a % of basic federal tax | 62.00 | 57.00 | 59.50 | 60.00 | n.a. | 53.00 | 52.00 | 50.00 | 46.50 | 51.50 | — |
| Base marginal rate, federal and provincial combined | 28.39 | 27.54 | 27.97 | 28.05 | 30.90 | 26.95 | 26.69 | 26.35 | 25.76 | 26.61 | 17.85 |
| Top marginal rate, federal and provincial combined | 49.30 | 49.50 | 50.30 | 48.72 | 50.54 | 48.23 | 50.40 | 49.56 | 46.38 | 46.26 | *31.32* |

[a] For details of low-income tax reductions, see Canadian Tax Foundation, *National Finances 1990* (Toronto: Canadian Tax Foundation, 1991), pp. 7:21, 7:26–7:27.

[b] Amount of tax payable after which the surtax is applicable.

[c] On net income in excess of $30,000.

Source: Authors' calculations based on information contained in forms for provincial income tax returns.

about the degree of variation in effective tax rates across the provinces by using more than one method of estimation. Here, we have done calculations by income class and by occupation. In Table 5, we show the effective tax rates — taxes paid divided by gross income — of married taxpayers with two dependent children for four income groups in 1990, based on estimates by the Canadian Tax Foundation (CTF). This effective tax rate measure is relevant to the migration decision in that, when moving from one province to another, an individual compares total taxes paid as a percentage of income. The differences range from 2.2 to 3.5 percentage points, depending on the income group.[8]

Table 5 also shows effective tax rates for two groups of self-employed professionals with incomes exceeding $100,000 in 1988, and compares them with the rates based on CTF estimates for the same year and for an income of $100,000. The rates in the bottom two rows take into account actual income composition (the CTF estimates do not), and the resulting impact of variations in the tax treatment of such income by province — for example, the impact of a flat tax on investment income. Effective tax rates were calculated from unpublished data from Revenue Canada for 1988; Quebec has had to be excluded. There are generally smaller provincial variations for these rates than for the CTF estimates for that year. Whereas Ontario, Alberta, and British Columbia have similar effective rates in the CTF case, British Columbia's was lower than the other two in the two occupational cases.

The relatively small provincial differentials in both effective rates (Table 5) and marginal rates (Table 4) are due not only to the TCAs, but also to the recognition on the part of some provincial governments of the risk of losing economic activity — and, therefore, tax revenue. The closeness of some neighboring rates suggests that

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[8] The estimates of tax payable that we have used here assume all income to be from Canadian employment. Credits or deductions for Canada Pension Plan (CPP) or QPP contributions and UI premiums are taken into account. The children are assumed to be 6 and 12 years old. No account was taken of exclusively provincial tax credits. For further details, see Canadian Tax Foundation, *The National Finances 1990* (Toronto: Canadian Tax Foundation, 1991), pp. 7:24, 7:26–7:27.

**Table 5:** ***Effective Federal and Provincial Personal Income Tax Rates for Selected Incomes (1990) and Occupations (1988)***

| | Personal Income Tax Rate | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | Nfld. | P.E.I. | N.S. | N.B. | Que. | Ont. | Man. | Sask. | Alta. | B.C. |
| *Income (1990)* | | | | | | | | | | |
| $20,000 | 4.0% | 3.7% | 3.8% | 3.9% | −1.4% | 2.0% | 1.0% | 3.5% | 3.0% | 3.3% |
| $40,000 | 23.3 | 22.5 | 22.9 | 23.0 | 22.9 | 22.0 | 22.8 | 23.6 | 21.4 | 21.7 |
| $75,000 | 34.8 | 33.8 | 34.3 | 34.4 | 36.2 | 33.0 | 35.8 | 35.2 | 32.4 | 32.7 |
| $100,000 | 38.4 | 37.3 | 38.2 | 38.0 | 39.8 | 36.6 | 39.4 | 38.8 | 35.9 | 36.1 |
| $100,000 (1988) | 37.3 | 36.4 | 36.5 | 37.3 | 40.5 | 35.3 | 39.2 | 38.2 | 35.3 | 35.4 |
| Doctors with income of $100,000 or more (1988) | 32.5 | 31.5 | 33.5 | 33.4 | [a] | 33.6 | 33.7 | 33.9 | 34.9 | 32.5 |
| Accountants with income of $100,000 or more (1988) | 30.5 | [b] | 30.0 | 30.4 | [a] | 30.5 | 28.8 | 28.9 | 29.6 | 28.5 |

[a] Quebec does not publish these data by occupation. the combined federal and Quebec effective rate for all taxpayers with an income of $100,000 or more was 32.8 percent.

[b] There were no accountants in this income group in Prince Edward Island in 1988.

Sources: Income tax rates by selected incomes are authors' calculations based on data for a married taxpayer with two dependent children under 16 years of age, from Canadian Tax Foundation, *The National Finances 1987–88* (Toronto: Canadian Tax Foundation, 1988), pp. 7:36, 7:38; and idem, *The National Finances 1990* (Toronto: Canadian Tax Foundation, 1991), p. 7:24. Income tax rates by occupation are authors' estimates based on unpublished 1988 taxation statistics by province from Canada, Department of National Revenue.

there are greater risks for some provinces — such as Nova Scotia and New Brunswick; Alberta, British Columbia, and Ontario — than for others. Since mobility is least likely among low-income groups, it is not surprising that the variations in effective tax rates were the largest for the $20,000 group. The *smallest* variations, however, were not within the highest-income groups; instead, they occurred at the $40,000 income level. This result is consistent with our hypothesis that highly mobile people take into account the whole tax-benefit system and not just a single component of it.

The developments in Quebec's tax structure provide some evidence of tax competition serving to bring about a considerable convergence in rates and base. Although the CTF estimates of effective rates show that Quebec's were the highest in 1990 for both the $75,000 and $100,000 income classes, they also indicate a considerable narrowing of differentials between Quebec and the other provinces for the $100,000 class from 1988 to 1990. Furthermore, in 1990, Newfoundland, New Brunswick, and Saskatchewan had higher effective rates for the $40,000 income class than Quebec. In fact, Quebec's effective rate structure was very similar to Manitoba's: the differentials between them were the smallest of any two provinces.

It should be recognized, however, that the existence of the TCAs, with nine participating provinces, has likely been a strong incentive for Quebec to harmonize much of its structure with that of the rest of the country. If there were ten separate systems and no federal PIT, the variations would likely be much greater. The continued presence of the federal government in the PIT field would be a powerful influence over the provincial systems even in the absence of the agreements.

## Simplicity

The most important benefit of the TCAs may be the savings they afford in the overall cost of administration and compliance. Harmonized tax bases, deductions, credits, and brackets are simpler to understand and to comply with than two separate systems would be, and the cost of one administration and one collection bureaucracy is obviously less than the cost of two. There are also economies in tax litigation.

There are various evaluations of such costs. The Saskatchewan government estimated that, by participating in the TCA, it saved approximately $30 million in 1988 in administrative expenses — or 3.3 percent of PIT revenues — and perhaps $50 million in compliance costs to the taxpayers and employers.[9] François Vaillancourt has studied the administrative and compliance costs of the PIT and payroll taxes in Canada — for the federal and Quebec systems combined — for 1986.[10] It is possible, however, using Vaillancourt's data, to estimate the administrative costs of the federal system separately from those of Quebec. The costs of administering the federal PIT, UI, and CPP came to 0.94 percent of revenues collected, while the costs of administering the Quebec PIT and QPP represented 1.33 percent of collections.[11]

When Vaillancourt was conducting his study, he was in contact with a group doing work on similar taxes in the United Kingdom. Each was able to report on the other, giving comparisons as a rough check on the validity of the results. In the case of the PIT, it has to be borne in mind that the self-assessment system in Canada shifts some of the burden of administration to the compliance of individuals, whereas in the United Kingdom, the Pay-As-You-Earn (PAYE) system exempts a large proportion of taxpayers from completing a return every year. It is not surprising, therefore, to find that the estimate of the federal system's administrative costs is lower than the estimate of comparable costs in the United Kingdom, which represent 1.5 percent of revenues.[12] It is interesting to note, however, that in the United Kingdom, the estimate of the administrative costs for the income and capital gains taxes alone — that is, without the payroll taxes — was 2.3 percent of the corresponding revenues,[13] suggesting that if the Canadian costs of collecting the PIT had been separated from the costs of administering the payroll taxes, administrative costs as a percentage of revenues would have been higher.

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[9] The estimates were for an established system. Saskatchewan, *A Dialogue*, p. 29.

[10] It should be noted that the costs associated with the PIT could not be completely separated from the costs associated with the CPP/QPP and UI premiums, so any conclusions drawn in the study about the operating costs of the PIT alone — and, in particular, of Quebec's PIT — must be considered significantly less reliable than the bundled results.

[11] As noted in the text, Vaillancourt calculated the percentages for the *combined* federal and Quebec taxes. The calculations here use his cost estimtates, but revenue figures from Revenue Canada and the Quebec Ministry of Revenue, plus the estimate of QPP contributions from Statistics Canada in the *Provincial Economic Accounts* (François Vaillancourt, *The Administrative and Compliance Costs of the Personal Income Tax and Payroll System in Canada, 1986* [Toronto: Canadian Tax Foundation, 1989], pp. 74, 78–79). The higher relative costs in Quebec are to be expected because of the much smaller population of taxpayers.

Vaillancourt's estimates of compliance costs for individuals come to 2.5 percent of revenues collected. This percentage is somewhat higher than the 2.2 percent for the United Kingdom. These costs are, however, for PIT compliance only; when they are related to PIT collections, the figures are 3.64 percent for the United Kingdom and 3.13 percent for Canada. (In light of the differences mentioned above, it is somewhat surprising to find that the Canadian costs are lower.)

In the case of employers' compliance costs, however, Vaillancourt's estimate for Canada (3.5 percent) is very much higher than the comparable estimate for the United Kingdom (1.02 percent). Sandford and colleagues note that "the difference could be accounted for by higher levels of PAYE income tax and NI [National Insurance] contributions in the United Kingdom, and (as suggested by Vaillancourt) the high costs associated with the Canadian unemployment insurance scheme."[14] A significant conclusion by Vaillancourt supporting the evidence of studies in other countries was that employer compliance costs are regressive — that is, they tend to be more burdensome for small firms than for large ones.[15]

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[12] Cedric Sandford, Michael Godwin, and Peter Hardwick, *Administrative and Compliance Costs of Taxation* (Bath: Fiscal Publications, 1989), p. 110.

[13] Ibid., pp. 108–109.

[14] Ibid., p. 108. Vaillancourt's surveyed employers estimated that roughly 50 percent of the cost was for payroll taxes, suggesting that compliance costs of the PIT are 2.2 percent, which is still more than double the cost in the United Kingdom.

[15] Ibid., p. 94; Vaillancourt, *Administrative and Compliance Costs*, pp. 50–51.

From the available evidence, it appears that, although the total operating costs of separate federal and provincial income tax systems are indeed higher than the costs of one harmonized system, the differences are significant but not as large as might have been expected. Nevertheless, provinces contemplating setting up an independent PIT regime or joining a regional system should bear in mind both the loss of economies of scale and the fact that a dual system would hurt small businesses more than large ones.

## Flexibility

Some of the benefits of a harmonized PIT system must be traded off against the limited flexibility each provincial signatory accepts with regard to the pursuit of economic or social objectives that differ from those of the federal government. Quebec has been able to adopt a radically different approach to the integration of the PIT and social transfers since the mid-1980s. Provinces that are locked into the federal system cannot attempt such innovations. Ontario, for example, could do little more than voice its desire that federal tax reform recognize the need for harmonizing the tax system and the social assistance system and "not preclude the introduction of a guaranteed annual income."[16] The success or failure of the Quebec experiment is likely to influence the federal government's decision about whether or not to move toward a similar integration.

The many complaints that have been voiced about this lack of flexibility suggest that there are, in fact, major differences in attitudes and preferences between the two levels of government and, perhaps, among the residents of different provinces. It is important to note, however, that the federal government's efforts to satisfy such complaints have reduced harmonization and simplicity and added to the costs of both administration and compliance, while only partially increasing the provinces' ability to pursue their own priorities.

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[16] Ontario, Budget Address, 1987, p. 17.

An examination of provincial PIT returns for 1990 discloses that the various add-ons have had to be accommodated on customized provincial schedules ranging in length from half a page, for three Atlantic provinces, to two pages, for Ontario and Manitoba. Increased flexibility, therefore, has involved a tradeoff in reduced simplicity. It is important, however, to recognize that a number of the provinces' add-ons do not really change the structure of the PIT but only simplify the delivery of social benefits. For example, Saskatchewan gives taxpayers credits for property taxes through direct payments, while Ontario does something similar through PIT credits. Using the income tax return as a means test eliminates administrative duplication.

## Accountability

The collection system under the TCAs tends to obscure the fact that there are two levels of government imposing separate taxes. Only at tax-return time does it become clear which level of government is raising what amount of tax — and it becomes clear only to those who prepare their own return, the percentage of whom appears to be in decline. The fact that the federal government virtually dictates the structure of the PIT for nine provinces means that the provincial tax burden can be changed without any action by provincial governments. Thus, the TCAs do not further the goal of accountability.

Problems of insufficient transparency do occur when the PIT field is co-occupied but the taxes are levied separately. The presence of two independent PIT systems in Quebec, with different tax deductions and credits as well as different tax brackets and rates, makes it almost impossible for Quebec taxpayers to assess the aggregate PIT impact. Outside Quebec, the TCAs might have been expected to solve this problem for their participants had there not developed an increasing reliance on add-ons to get around the federally determined structure of the tax base and rate. The increasing number of variations confronting taxpayers in many provinces makes it very difficult for them to comprehend the impact of the combined federal-provincial tax.

## Equity

Questions of equity have had a higher profile in discussions of the PIT than of any other tax sources, since the PIT lends itself to income redistribution better than any other tax. Thus, vertical equity is the major issue that arises in relation to the PIT.

The provincial governments participating in the TCAs are severely constrained when, as has often happened, they do not agree with the federal government's interpretation of fairness as embodied in the PIT tax structure. Some disagreements have been about the proliferation of tax shelters and the definition of the federal PIT base, while others have focused on the degree of progressivity in the structure. Before 1988, complaints were often voiced about the use of exemptions and deductions instead of tax credits.

The argument against deductions and exemptions is that they give a greater benefit to high-bracket taxpayers.[17] When the federal government, in its 1988 tax reform, replaced most exemptions and deductions with credits, the TCA participants had to accept the entire package. It may have been, however, that they had other views, as did Quebec. Although Quebec adopted most of the federal changes, it assessed the equity implications of the use of deductions and credits differently. It also retained a deduction for employment expenses, even though the federal government had eliminated it.

One contentious aspect of the PIT base was the lifetime capital gains exemption introduced in the 1985 federal budget. Manitoba introduced its separate flat tax on net income in 1987 because it felt that this exemption, together with the proposed increase in Registered Retirement Savings Plan contribution limits, added to the shift in the tax burden from "high-income, wealthy corporate shareholders to ordinary working Canadians."[18] In addition to taxing capital gains, the flat tax bypassed such deductions as losses of other years. This was a clumsy way of dealing with the problem, however, because it also taxed all other income, reducing progressivity in the process. The flat tax therefore had to be complemented by a tax reduction for low-income earners and a surtax on the flat tax for high-income taxpayers. Saskatchewan had already introduced a similar tax in 1985 to "limit the erosion of the tax base" by tax shelters, which included the capital gains exemption — although it was not mentioned specifically.[19] In 1987, Ontario also expressed its concern about the unfairness of the capital gains exemption, but took no specific action.

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[17] Unfortunately, many governments and policy groups in Canada have confused progressivity with horizontal equity. The argument that credits are preferable to deductions for income-distribution reasons is based on the premise that, because marginal tax rates increase as income rises, deductions are more valuable to the rich than the poor. However, this analysis is faulty, since the point of deductions is to measure properly a tax base before the rate structure is applied. It is, therefore, appropriate to deduct expenses related to gaining income rather than have them converted to tax credits. Such expenses would include tuition fees, UI premiums, and so on (Canada, Royal Commission on Taxation, *Report* [Ottawa: Queen's Printer, 1966]).

As a result of their dissatisfaction with the insufficient degree of progressivity of the federal tax system, many provinces resorted to tax reductions for low-income individuals and surtaxes for high-income taxpayers. Selective tax reductions for taxpayers whose income falls below a set level make the PIT more progressive, altering the basic tax structure of the system. Such low-income tax reductions have been available in Ontario and the Western provinces for some time, although British Columbia cancelled this feature in 1990. Their impact on the degree of progressivity in 1990 ranged from very small in Ontario, where they were eliminated at $8,477, to quite large in Manitoba, where they were phased out at $21,500. Surtaxes had been introduced at the provincial level well before the federal government reintroduced them in 1985, after 13 years without them. They were the preserve of Ontario and the Western provinces until 1988; then Prince Edward Island, Nova Scotia, and New Brunswick followed suit. By 1991, all participants in the TCAs but Newfoundland had high-income surtaxes, three of which started at lower relative thresholds than the federal government's.

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[18] Manitoba, Budget Address, 1987, p. 28.

[19] Saskatchewan, Budget Address, 1985, pp. 11, 44–46.

If the question of the desirable degree of progressivity of the PIT were resolved to the mutual satisfaction of the federal government and the provinces, it would seem that the provinces participating in the TCAs would need only to set their tax rates as a percentage of the basic federal tax, rather than having to introduce various add-ons. In fact, however, Ottawa itself became a source of divergence between the two levels of government when it introduced a 5 percent credit against the basic federal tax in 1973;[20] since then, it has from time to time added other supplemental measures, including tax credits — for investment, employment, political contributions, scientific research, and so on — and, since 1985, surtaxes. These measures cumulatively amounted to such a significant superstructure to the basic federal tax that, unless the provinces mirrored them, the degree of progressivity of their own systems had to differ from that of the federal government.

Most provinces have indeed introduced their own array of add-ons to the basic federal tax, but rarely for the purpose of maintaining harmony with the overall federal structure. Some of these add-ons, for example, were designed to increase the burden on high-income taxpayers relative to that imposed by the federal structure. When estimating each province's resulting effective tax rate in order to make interprovincial tax comparisons, we should take into account only those additions that modify the basic tax structure, and ignore those that are piggybacking on the income tax return for the purpose of income testing and delivering social programs — for example, sales tax or cost-of-living and property tax credits. (The fact that some provinces have chosen to handle these types of programs through grants supports this treatment.) Similarly, at the federal level, the child tax credit is an alternative form of family allowance payment. In practice, it is not always possible to exclude such credits from effective tax rate calculations.

The provincial PIT structures have enough true income tax credits as well as flat taxes and surtaxes to complicate any attempt to assess their relative degrees of progressivity through a comparison of the statutory rates alone. A study of progressivity conducted by R. Howard and colleagues was not, unfortunately, able to take into account the effect of credits such as those for Stock Savings Plans (SSPs), venture capital, or political contributions. The authors found that, in 1990, the PIT structures of Manitoba, Alberta, and Ontario were substantially more progressive than the federal structure.[21] This result was attributable to these provinces' much higher zero-rate income thresholds than the federal government's, as well as to the structure of their surtaxes. SSPs were available in Newfoundland, Nova Scotia, New Brunswick, and British Columbia, and various types of venture capital credits were available in Newfoundland, Saskatchewan, and British Columbia. If the effects of these programs could have been measured, it may have been found that they made these provinces' PITs less progressive, implying an even greater discrepancy between their tax structures and those of Manitoba, Alberta, and Ontario.

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[20] The credit rose to 9 percent between 1977 and 1981, but was phased out by 1985.

## *Vertical Equity between Quebec and the Federal System*

It would have been less surprising to find that, in terms of its progressivity, Quebec's PIT differed most from the federal government's. But, while the Howard study did find that Quebec's PIT was significantly more progressive, due to both its higher zero-rate income threshold and its more generous dependant tax credits, it also found, unexpectedly, that it was not as progressive as Manitoba's. Since Quebec had a number of programs more likely to be used by higher-income than lower-income taxpayers — Quebec SSP and other investment incentives — its PIT may also have been less progressive than Alberta's and Ontario's.

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[21] R. Howard, G. Ruggeri, and D. Van Wart, "The Progressivity of Provincial Personal Income Tax in Canada," *Canadian Tax Journal* 39 (1991): 306.

### *Are There National Standards of Equity?*

The Howard study found that, in terms of progressivity, six out of ten provinces were strongly harmonized with the federal system. Nonetheless, the fact that there were major differences in three provinces participating in TCAs showed that even harmonization could not ensure that all provincial tax structures would be characterized by a similar degree of progressivity. In fact, the tax structure of a province not participating in a TCA may be closer to the federal structure than that of a participating province.

On the other hand, the existence of the two systems in Quebec has fostered experimentation that can benefit everyone — for example, the two approaches to credits and deductions and Quebec's integration of the zero-rate income threshold with income transfers. Furthermore, the Quebec government has been able to accommodate objectives that are important to it but not particularly relevant to other provinces, such as a higher birthrate.

## The Future of the Tax Collection Agreements

The fact that the TCAs have survived for almost 30 years may credit them with greater merit than they deserve. It should be noted that any benefits they bring to one of the participating levels of governments usually represents a cost to the other level. For example, the federal government has the power to establish, for virtually the entire PIT system, the components of income that will be assessed. With its power to define tax brackets and rates, it is able to determine how progressive the basic tax will be. In addition, the federal government can incorporate incentives for the economic activities it favors — for example, the capital gains exemption. The cost to the provinces of the federal prerogatives is the flexibility they give up in setting their own social and economic priorities. On the other hand, the provinces benefit from huge savings in administrative costs, which the federal government bears. In addition, when the federal government raises tax rates or broadens the tax base, the provinces get a windfall increase in revenues without the political pain of legislating the increase. When the federal government reduces taxes, however, they can blame it for forcing them to make compensatory increases in their own tax rates; on some occasions, they can even pry compensatory federal transfers from the situation. Nevertheless, the only costs and benefits associated with the TCAs that ultimately matter are those to taxpayers and the economy.

More than one province has seriously considered ending its participation in the TCAs. A massive study on a separate personal income tax for Ontario was undertaken in 1983; Ontario decided, on the basis of it, to remain in the TCA "for the time being."[22] Saskatchewan began to discuss the possibility of "a significant departure from the traditional federal-provincial tax collection relationship" in 1988.[23] After extensive public consultation about alternative arrangements, taxpayers expressed the concern that the tax form would become too complex if the province had a separate marginal tax structure.[24] In 1990, British Columbia made a public statement about the flaws in the TCAs and presented some alternative options, which included separate income tax collection by the provinces.[25]

Despite their misgivings about the TCAs, the provinces are reluctant to incur, on behalf of their citizens, the additional administrative or compliance costs associated with a separate PIT system. Smaller provinces — especially the "have-not" provinces — would find it very burdensome to collect their own PIT. Saskatchewan has been open about the disincentive to setting up its own system that the high cost of administration and compliance represents.[26] Such provinces may, however, opt for a regional tax collection system if the federal government does not permit more flexibility in the operation of the TCAs.[27] In 1990, the four Western provinces announced that they were studying the possibility of setting up their own regional PIT administration.[28]

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[22] Ontario, Budget Address, 1983, Appendix, p. 4. See also D. Hartle, *A Separate Personal Income Tax for Ontario: An Economic Analysis* (Toronto: Ontario Economic Council and the University of Toronto Press, 1983).

[23] Saskatchewan, *A Dialogue*, p. 21.

[24] Saskatchewan, *Saskatchewan's Tax System for the 1990s: Challenges and Opportunities*, March 1989, p. H.6.

[25] The Hon. Mel Couvelier, "Resolving Canada's Fiscal Situation through Renewed Federalism and Fiscal Discipline" (Statement delivered on September 10, 1990), pp. 8–9.

[26] Saskatchewan, Budget Address, 1984, p. 43.

If the provinces exercise more autonomy in the PIT field, will they use it to add to the "self-defeating competition" that provincial incentive grants to industry are already creating?[29] Quebec's use of PIT incentives to promote economic activity raises the question of the extent to which other provinces might do the same if they left the TCAs. In 1990, Quebec residents could avail themselves of eight separate deductions under the heading "strategic investments for the economy." The Quebec SSP had already inspired five other provinces to implement tax credits for such plans (some of them have now expired). Saskatchewan's venture capital corporation program is similar to Quebec's in that it is confined to specified industries, and its livestock credit might be compared with Quebec's deduction for resources. Quebec's deduction for certified Quebec films, however, has remained unique. Finally, Quebec allows deductions for shares in credit unions and business investment companies and has one that is reminiscent of the federal government's scientific research and development tax credit. From the Quebec experience alone, one might conclude that economic incentives would indeed be expanded if other provinces dropped out of the TCAs and that some provinces — Saskatchewan seems an obvious example — would use them more than others.[30] It is not clear, however, how much damage they would do to other provincial economies. They would certainly create distortions in the allocation of resources in the provinces that introduced them.

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[27] Saskatchewan may have been thinking of joining a Western regional system when it threatened to consider other avenues to achieve its priorities if no federal-provincial agreement on tax collections were possible. See Saskatchewan, Budget Address, 1990, p. 25–26.

[28] See, for example, the section entitled Option 2: Income Tax Collection by the Provinces, in Couvelier, "Resolving Canada's Fiscal Situation."

[29] The minister of finance of New Brunswick mentioned that his government would raise the issue of competing financial incentives to industry with the Council of Maritime Premiers to see whether these provinces could "limit this kind of self-defeating competition" (New Brunswick, Budget Address, 1991–1992, p. 25). These concerns apply equally to some tax expenditures in the PIT system.

The renewed pressure for change in the TCAs by the Western provinces from 1990 to 1991 elicited a response from the federal government in 1991 in the form of a discussion paper.

## *The Federal Government's Discussion Paper*

The federal government's discussion paper, entitled *Personal Income Tax Coordination*, emphasizes the importance of a single definition of taxable income.[31] It is this definition, however, that has upset the provinces from time to time. A changed approach to the TCAs should certainly incorporate a formal mechanism for provincial input in determining the composition of total income — as, for example, the British Columbia government has emphasized) and the deductions that are allowed for calculating taxable income.

In the discussion paper's illustrative model, all participants in the TCAs are permitted to extend the number of tax brackets (to a certain limit) and to set their own rates. In the case of nonrefundable tax credits, the illustrative model suggests that the province accept a basic block of 16 federal personal tax credits. Each province would then be able to modify six of these credits. These proposals for increased provincial flexibility would probably be sufficient to satisfy some of the provinces' desire to modify the impact of the federal PIT structure on income distribution and thus to accommodate their particular views about progressivity and so forth. Other provinces might find, however, that the ability to modify the federal government's nonrefundable tax credits does not enable them to meet all of their objectives; it may therefore be desirable to allow a limited number of provincially designed credits as well. A condition of this increased flexibility for the provinces should, however, be that special-interest tax shelters are not allowed.

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[30] In 1988, Saskatchewan's minister of finance affirmed the government's intention to continue to target support for specific provincial objectives through the Saskatchewan Tax Incentives Program (Saskatchewan, *A Dialogue*, p. 6).

[31] Canada, Department of Finance, *Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements* (Ottawa, June 1991), p. 40.

As long as there is a single collection system, the problems of accountability and transparency will remain. The discussion paper suggests that each government's tax should be shown separately on pay checks, which would improve accountability, albeit in a limited way. As long as the federal government designs virtually the entire PIT structure, which the discussion paper appears to advocate, the federal government will remain responsible for that basic structure. In this sense, accountability will not improve if federal amendments are undertaken unilaterally, without provincial input.

From the experience of Quebec's two tax systems, it can be concluded that greater autonomy within the TCAs may not impose an overly burdensome additional cost on either the public or the private sector. There would certainly be an offsetting cost reduction in the removal of the present customized personal credits, tax reductions, surtaxes, and flat taxes. Greater flexibility may also confer the benefit of a province's PIT structure's better matching the preferences of its residents and at the same time lending itself better to an integration of taxes and transfers. There is, however, the consideration that any increase in compliance costs is likely to be borne in greatest part by the small business sector. With this in mind, provincial variations should be limited to those that can be accommodated in centrally designed source-deduction tables.

Provinces that were to take advantage of the opportunity to design their own tax structure would no doubt undertake a series of public consultations, as Saskatchewan has done, and might also find that public enthusiasm for a significant departure from the federal structure is very weak.

## Recommendations

The PIT is the most important source of revenue for both the federal and the provincial governments. Under the present arrangement for federal-provincial sharing of spending responsibilities, it is critical that both levels of government have access to the PIT. Only a massive centralization or decentralization of spending powers could make the consolidation of this tax with either the federal government or the provincial governments feasible. And even if the PIT could be transferred wholly to either level of government, compliance costs would likely fall but other inefficiencies might arise. There are other reasons for the federal government to retain a major share of the PIT: its progressivity makes it an important source of finance for equalization, and it can be used for the delivery of federal income transfers. In our opinion, therefore, the two levels of government should continue to co-occupy the PIT field. Moreover, we believe that the TCAs have been valuable and should be continued.

The problem of federal domination is likely to keep recurring, however, without some accommodation of provincial differences in the definition of equity and the desire to use the PIT as a vehicle to deliver income-tested social programs. A more flexible arrangement would, therefore, be a valuable compromise if only to avoid the unnecessary duplication in administration and the additional costs of compliance that two separate systems would entail. At the end of its study on the implications of a separate PIT for Ontario, the Ontario Economic Council recommended further exploration of the following:

- a federal-provincial tax structure committee that would allow joint input into the determination of the common tax base;
- a move toward a "tax on base" system as opposed to the present "tax on tax" system;
- an extension of the tax-credit system to provide the province with more freedom to implement nondiscriminatory measures within its portion of the joint PIT.[32]

The tax-credit system was, in fact, extended by the federal government as part of its 1988 PIT reform. This enabled Ottawa to incorporate in its illustrative model an option for individual provinces to determine provincial values of and criteria for eligibility for nonrefundable credits. Since the model also featured a tax on income — that is, a tax on base — system for the provinces, two of the Ontario Economic Council's proposals were in fact addressed. The first of the proposals listed above remains to be explored, along with the Council's recommendation that a "code of economic conduct" be established to ensure the preservation of the internal economic union not only within the tax system but across the entire fiscal and regulatory front. A strong mechanism to deal with the existing and any possible new PIT impediments to the free flow of goods, services, labor, and capital would remove the major obstacle to a more flexible TCA system while retaining its advantages.

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[32] Ontario Economic Council, *A Separate Personal Income Tax for Ontario* (Toronto: Ontario Economic Council, 1983), p. 164.

# Chapter 5

# *Payroll Taxes*

Both levels of government have been relying more on payroll taxes during the past few years. Ontario and Newfoundland recently joined Quebec and Manitoba in levying a general payroll tax, and the previous British Columbia government may well have followed suit.[1] Ottawa has considered using a payroll levy to pay for wage claims and, furthermore, has chosen to cover more of the cost of manpower training with unemployment insurance (UI) premiums.

## Structure

Payroll taxes may be categorized, according to Vaillancourt and Marceau,[2] as general or firm/industry-specific. General payroll tax rates are applied to all types of payrolls at the same rate. Firm-specific payroll taxes vary with the experience of the firm or industry. The significance of this distinction is to gain some further insight into the complex question of whether or not payroll taxes, by reason of their incidence, should be treated as personal, corporate, or benefit taxes. Some studies suggest that general payroll taxes are borne primarily by employees, whereas firm-specific levies are not.[3] There is only one payroll tax in Canada that is firm-specific — Workers' Compensation Board (WCB) premiums. We have therefore assumed that the others are ultimately borne by employees and that they can consequently be viewed as a substitute for personal taxes. The following list covers the bulk of these taxes.

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[1] In 1991, British Columbia's finance minister mentioned that he was reviewing revenue measures to replace the Medical Services Plan premiums (British Columbia, Budget Address, 1991, p. 15).

[2] F. Vaillancourt and N. Marceau, "Do General and Firm-Specific Payroll Taxes Have the Same Incidence? Theory and Evidence," Cahier 0889 (Montreal: Université de Montréal, Centre de recherche et développement en économique, April 1989), p. 2.

[3] A comprehensive review of studies dealing with the incidence of payroll taxes may be found in B. Dahlby, "Taxation and Social Insurance," in R. Bird and J. Mintz, eds., *Taxation to 2000 and Beyond* (Toronto: Canadian Tax Foundation, forthcoming).

- The Canada and Quebec Pension Plans (CPP and QPP) are financed by premiums on earned income above a minimum threshold and are shared equally by employers and employees. As these are not part of federal or Quebec general government revenues, we do not consider them here.
- Apart from the CPP, the federal government uses the payroll tax field to fund only the UI program. Premiums are levied on individuals' earnings and are shared by employers and employees at a ratio of 1.4:1. Payrolls include not only wages and salaries but also the self-employed income of individuals. We note that this is not true for the provincial payroll taxes, which most often exclude self-employed income.
- Quebec levies a health services tax entirely on employers to fund part of its health-care expenditures. The tax is levied on gross payrolls at 3.75 percent (as of September 1, 1991). The tax was worth $2.65 billion in 1990.
- In 1990, Ontario replaced health insurance premiums with a tax on employers set at 0.98 percent of gross payrolls of less than $200,000 a year and at 1.95 percent of payrolls of more than $400,000, with graduated rates in between. The tax was worth $2.6 billion in 1990.
- Newfoundland introduced a Health and Post-Secondary Education Tax in August 1990 at 1.5 percent of payrolls exceeding $300,000 a year, with exemptions for primary producers and secondary processors in fisheries, forestry, and agriculture. Revenues of $25 million were expected for fiscal year 1991/92.
- Since 1982, Manitoba has also relied on a payroll tax on employers to help finance postsecondary education and health. It is set at 2.25 percent of payrolls exceeding $1.2 million and at reduced

rates for payrolls between $600 thousand and $1.2 million. Revenues of $180 million were collected in fiscal year 1990/91.

- All provinces have Workers' Compensation Boards and use a premium system levied on employers only.
- Although health insurance premiums are not payroll taxes, a large proportion of the revenues from them is paid by employers, and they are therefore included in this category for convenience. By 1990, only two provinces — Alberta and British Columbia — still used them. Their combined revenue amounted to about $850 million in 1989.

## Efficiency

If general payroll taxes are eventually borne by workers, they do not affect the firm's competitive position. They do, however, distort labor demand and/or supply. UI premiums, in addition, bear no relation to the unemployment risks of the province or to the employee's or the firm's employment history; they therefore retard labor adjustment through interprovincial mobility. This is important to keep in mind, since unemployment insurance is a federal, not a provincial, policy that reduces economic gains from the free flow of labor.

WCB premiums, in contrast, bear some relation to risk since their rates vary with the accident and claim experience of the industry. (In Ontario, the experience of the individual firm gives rise to a premium refund or supplement.) Furthermore, since WCB premiums are within the provinces' domain, they also reflect differences in provincial experience.

Finally, all provincial payroll taxes fall only on salaries and wages, not on labor income derived from unincorporated businesses. This creates a potential inefficiency for firms, one that may encourage them to use contract labor rather than employees. It should be noted, however, that the provincial exemption of unincorporated business income reflects the simple fact that provinces do not collect the personal income tax (PIT), and that unincorporated business income is reported as personal income. Under current Tax

Collection Agreements, payroll taxes on such income would have to be collected by the federal government.

## Simplicity

A virtue of payroll taxes is that, taken individually, they can be simple. However, an assortment of simple taxes is anything but simple. Furthermore, even a simple tax may not be cheaper to operate than a more complex tax, as Vaillancourt's study of the operating costs of the PIT and payroll tax systems suggests. Because the administration and compliance of social security taxes are closely tied to those of the PIT, studies have had difficulty separating them and, unfortunately, there are no studies of the costs of operating the various Canadian provincial payroll taxes.[4]

Vaillancourt was unable to separate the administration costs of the UI, CPP/QPP (payroll taxes), and the PIT. A sense of the relative administrative costs of the PIT and payroll taxes may be gleaned from work carried out in other countries. For example, there are broad similarities between UI in Canada and National Insurance (NI) in the United Kingdom, and a study of that country's system found that the administrative costs associated with NI were 0.4 percent of revenues collected compared with 2.3 percent for its PIT. Since Vaillancourt found that the administrative costs of combined PIT, UI, CPP/QPP (direct personal taxes) in Canada were 1 percent of revenue, it is likely that the costs of the payroll taxes were lower than 1 percent.

In the case of employer compliance costs, on the other hand, the firms sampled in the Vaillancourt study indicated that the costs associated with the payroll taxes represented roughly 50 percent of compliance costs of all direct personal tax remittances.[5] Since UI and CPP/QPP premium revenue amounted to only about 20 percent of total direct personal tax revenue in 1986, the compliance costs of these social security taxes works out to about 8.7 percent.[6] This estimate may not be replicated for the various provincial payroll taxes, but the fact is that, in more and more cases, employers are dealing with not only these two payroll taxes but with four, each of which has its own peculiar structure. Most are also dealing with two levels of government as well as with the boards that operate the Workers' Compensation system.

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[4] See footnotes 10 and 11 in Chapter 4.

[5] François Vaillancourt, *The Administrative and Compliance Costs of the Personal Income Tax and Payroll System in Canada, 1986* (Toronto: Canadian Tax Foundation, 1989), p. 51.

It is true that the compliance costs associated with the various payroll taxes are minimal for individuals, but payroll taxes as a group cannot be described as forming a simple system. From a business perspective, the burden of compliance associated with multiple payroll taxes may well be even greater than that associated with the corporate income tax.

## Accountability

The fact that most payroll taxes are levied on the employer obscures the true incidence of the tax. There is a strong connection between WCB premiums and benefits and a weaker one between UI premiums and benefits.[7] The UI program has been a source of interprovincial transfers of income — something that is not transparent to voters. The federal government operates the equalization program to redistribute income among regions; there is no clear rationale for the UI program to be used as an adjunct to this or as a separate interregional transfer program. Calling a payroll tax a health-care levy or something similar does not improve accountability when the connection between the tax and the expenditure on health care is indistinct.

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[6] Since the compliance costs of the combined PIT and social security premiums were more than double, in percentage terms, the U.K. costs for comparable collections, Vaillancourt concluded, as noted in the previous chapter, that it was due to the high costs associated with the unemployment insurance and public pension systems. Vaillancourt did not address the question of why this should be so.

[7] The link has become fuzzier as more and more social benefits, such as fishermen's benefits, and training-program costs are being funded by the employer/employee UI premiums.

## Equity

Unlike the PIT, which is designed to exempt low-income earners, most payroll taxes involve few, if any, exemptions: they are characteristically flat rather than progressive. The only payroll tax still in existence that is levied on individuals' earnings rather than on gross payrolls, the UI premium, is regressive because there is a maximum annual contribution level, which is analogous to the capping of benefits. It is likely that payroll compliance costs are also regressive.[8]

To the extent that UI premiums do not reflect the layoff practices of employers or the claims history of employees, they are unfair as well as inefficient.

The payroll taxes that are levied by the provinces independent of the federal government fall on individuals' labor income proportionately at best. Progressive rate structures, where they exist — for example, Ontario's and Manitoba's general payroll taxes — are applied to the firm's overall payroll and are unrelated to individual wages or salaries. A few provinces have even contemplated providing a credit through the income tax to offset the regressive, or proportional, nature of the payroll tax. In fact, the federal government has equally never contemplated this option.

A general view put forward by provincial governments is that payroll taxes operate as "user fees," paying for benefits offered by the government to the taxpayer. But true user fees for provincial programs would create no spillover effects across provinces and would represent fair, direct payments for provincial public benefits. These conditions are in fact not fulfilled by general payroll taxes, which form part of general revenues and are not linked directly with any particular benefits.

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[8] Vaillancourt, *Administrative and Compliance Costs*, p. 50.

## Recommendations

If payroll taxes are user fees for benefits, it is rational to have both levels of government using the payroll taxes to fund social insurance programs. But most payroll taxes are not user fees. Although the federal government's proposed legislation to limit the deductibility of general payroll taxes for corporate income tax purposes has reduced their attraction as a source of revenue for the provinces, it is not clear that they will disappear altogether, especially in provinces that have significant federal payrolls. The federal government may also turn to general payroll taxes.

If it is accepted that such taxes are eventually borne by employees, then there is a strong argument, on grounds of equity, to use the PIT instead, as it does not burden low-income workers as heavily. The need to simplify the entire tax structure is another reason to avoid using payroll taxes. We would therefore argue for the elimination or at least the limitation of general payroll taxes. It would be appropriate for the federal and the provincial governments to harmonize these payroll taxes in an effort to achieve greater simplicity.

# Chapter 6

# *Corporate Income and Related Taxes on Business Capital*

## Structure

The federal and provincial governments levy two types of taxes on capital: (1) the corporate income tax (CIT), which applies to income earned by shareholders — revenue net of wage, interest, depreciation, and material-purchase costs; and (2) the capital tax, which applies to the "paid-up capital" of a company — shareholders' equity plus qualifying debt liabilities. We shall discuss the structure of each tax, then evaluate both in terms of the criteria outlined in Chapter 1.

### *The Corporate Income Tax*

Three provinces — Quebec, Ontario, and Alberta — administer their own CIT. The remaining seven provinces have Tax Collection Agreements (TCAs) with the federal government. As with the TCAs for the personal income tax, the federal government collects the tax on behalf of the provinces, and the provinces agree to use the federal government's definition of taxable income. In the case of the corporate TCAs, however, the provinces are allowed to assess a rate of tax as a percentage of corporate *taxable income*, rather than of federal taxes payable, as in the case of the personal income tax.

In all provinces, including those that do not have a TCA with the federal government, the tax base is allocated according to a formula that eliminates multiple taxation by several provinces of the same source of corporate income. The general formula requires corporate income to be allocated to each province according to an average of the provincial shares of revenues and payroll earned in Canada by company. Special rules apply to certain special industries such as finance and transportation.

With or without the TCAs with Ottawa, divergences among provinces and tax competition are possible in terms of the statutory corporate income tax rates. These rates, which vary with industry (manufacturing or nonmanufacturing) and company size, are shown in Table 6. There is considerable divergence in rates between Quebec, which imposes a rate of 6.33 percent on many large companies, and Ontario, which levies a tax of 15.5 percent on large companies in nonmanufacturing industries (and 14.5 percent in manufacturing and mining industries). Small businesses are taxed at lower rates. Some provinces, such as Nova Scotia and Saskatchewan, continue to grant "tax holidays," wherein companies are allowed not only to earn tax-free income for two or three years, but also to delay taking depreciation deductions until after the holiday is over.[1]

The history of Quebec's low statutory tax rate attests to the kinds of incentives and pressures that arise when a province is free to levy its own corporate income taxes. In 1981, Quebec dramatically reduced CIT rates in favor of a higher tax rate on business capital (as we shall discuss below). One reason the government gave for the change was that it wished to eliminate the incentive for large companies to try to shift taxable income out of the province, since its tax rate, added to the federal rate, had been greater than the rates that prevailed in many other countries. A second reason — and one favored by Ottawa — might have been that Quebec was trying to shift the tax burden onto the federal government. Unlike the provincial CIT, the capital tax is deductible from the federal CIT base. With a shift to the capital tax from the CIT, companies in Quebec save taxes, and the federal government shares the burden of the capital tax, at the effective federal tax rate of 36 percent (now 28.84 percent).

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[1] Tax holidays in the mining industry are discussed under Taxes on Natural Resources. See Jack M. Mintz, "Corporate Tax Holidays and Investment," *World Bank Economic Review* 4 (1990): 81–102.

## Table 6: *Federal and Provincial Corporate Income Tax Rates, 1990 and 1991*[a]

| | Nfld. | P.E.I. | N.S. | N.B. | Que. | Ont. | Man. | Sask. | Alta. | B.C. | Y.T. | N.W.T. | Fed. |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | | *Rates effective July 1, 1990* | | | | | | |
| *Small, Canadian-controlled corporations* | | | | | | | | | | | | | |
| Manufacturing | 10.00 | 10.00 | 10.00 | 9.00 | 3.45 | 10.00 | 10.00 | 10.00 | 6.00 | 9.00 | 2.50 | 8.00 | 12.81 |
| Nonmanufacturing | 10.00 | 10.00 | 10.00 | 9.00 | 3.45 | 10.00 | 10.00 | 10.00 | 6.00 | 9.00 | 5.00 | 8.00 | 12.81 |
| *Other corporations* | | | | | | | | | | | | | |
| Manufacturing | 17.00 | 15.00 | 16.00[b] | 16.00 | 6.33 | 14.50 | 17.00 | 15.00 | 15.00[e] | 14.00[f] | 2.50 | 12.00 | 24.81 |
| Nonmanufacturing | 17.00 | 15.00 | 16.00[b] | 16.00 | 6.33 | 15.50 | 17.00 | 15.00 | 15.00[e] | 14.00[f] | 10.00 | 12.00 | 28.81 |
| | | | | | | | *Rates effective July 1, 1991* | | | | | | |
| *Small, Canadian-controlled corporations* | | | | | | | | | | | | | |
| Manufacturing | 10.00 | 10.00 | 10.00 | 9.00 | 3.45[c] | 10.00 | 10.00 | 10.00 | 6.00 | 9.00 | 2.50 | 5.00 | 12.81 |
| Nonmanufacturing | 10.00 | 10.00 | 10.00 | 9.00 | 3.45[c] | 10.00 | 10.00 | 10.00 | 6.00 | 9.00 | 5.00 | 5.00 | 12.81 |
| *Other corporations* | | | | | | | | | | | | | |
| Manufacturing | 17.00 | 15.00 | 16.00 | 17.00 | 6.33[d] | 16.00 | 17.00 | 15.00 | 15.50 | 15.00 | 2.50 | 12.00 | 23.81 |
| Nonmanufacturing | 17.00 | 15.00 | 16.00 | 17.00 | 6.33[d] | 16.00 | 17.00 | 15.00 | 15.50 | 15.00 | 10.00 | 12.00 | 28.81 |

[a] Federal rates include 3 percent corporate surtax; all rates apply to active business income.

[b] Rate effective January 1, 1991, will change to 17.00 percent.

[c] Rate effective September 1, 1991, will change to 3.75 percent.

[d] Rate effective September 1, 1991, will change to 6.90 percent.

[e] Rate effective April 1, 1991, will change to 15.50 percent.

[f] Rate effective January 1, 1991, will change to 15.00 percent.

Source: Arthur Andersen & Co., *Canadian Tax Notes* (Toronto, 1991).

In certain cases, the provincial definition of taxable income may also diverge from the federal definition, so long as the federal government agrees to collect the tax using the province's provisions. For example, when the federal government disallowed the deduction of resource royalties and mining profits from taxable income, Saskatchewan and British Columbia provided a tax credit that essentially allowed companies to preserve the full value of the former resource royalty deductions. The federal government accepted a similar provision by Saskatchewan to grant "automatic" depletion — a writeoff equal to a percentage of mining profits — as opposed to earned depletion — a writeoff equal to a percentage of expenditures on exploration and development.

The structures of the three separate provincial CIT systems (in Ontario, Quebec, and Alberta) are very similar to the federal one because most of the changes introduced by Ottawa have also been adopted by those provinces. Indeed, in response to the federal corporate tax reform, Ontario even contemplated re-entering a Tax Collection Agreement. The Ontario government currently provides four or five writeoffs that diverge significantly from the federal base, among them a 30 percent deduction for qualifying equipment expenditures, a superallowance for research and development, and automatic depletion for mining companies — which is now being phased out in favor of a resource allowance.

## *Taxes on Business Capital*

Taxes on the paid-up capital of corporations[2] proliferated during the 1980s, but Quebec and Ontario had imposed them long before that — Quebec after World War II, and Ontario in 1957. The remaining provinces did not follow suit for some years: British Columbia introduced a paid-up capital tax on financial corporations alone in 1973, and Manitoba and Saskatchewan introduced capital taxes in

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[2] In addition to taxes on capital, insurance companies are subject to taxes on insurance premiums. However, these taxes act as a form of consumption tax rather than as capital taxes, which are the subject of this section.

**Table 7: *Capital Tax Rates by Province, 1991***

| | General | Financial Institutions |
|---|---|---|
| | *(percent)* | |
| Newfoundland | | 3.00 |
| Prince Edward Island | | 3.00 |
| Nova Scotia | | 3.00 |
| New Brunswick | | 3.00 |
| Quebec | 0.56[a] | 1.12 |
| Ontario | 0.30 | 1.00 |
| Manitoba | 0.30/0.50[b] | 3.00 |
| Saskatchewan | 0.50[c] | 3.00 |
| Alberta | | 2.00 |
| British Columbia | | 2.00[d] |

[a] Effective September 1, 1991.

[b] The higher rate applies to capital in excess of $10 million.

[c] An alternative capital tax is imposed on large companies.

[d] Banks with capital in excess of $500 million and permanent establishment in British Columbia.

Source: Arthur Andersen & Co., *Canadian Tax Notes* (Toronto, 1991).

1976 and 1980, respectively. The Atlantic provinces came next: Newfoundland introduced paid-up capital taxes on financial institutions in 1982, Nova Scotia in 1986, New Brunswick in 1987, and Prince Edward Island in 1988. Alberta was the last province to impose a capital tax (on financial institutions) in 1991.

A general capital tax is now imposed on all corporations in four provinces: Quebec, Ontario, Manitoba, and Saskatchewan. British Columbia had a general capital tax before 1985, limited to out-of-province financial companies. In 1987, the B.C. capital tax was modified to apply to capital in excess of $500 million held by banks and trust and loan companies. (The general tax was reintroduced in the 1992 budget.) The rates of capital tax for 1991 are reported in Table 7.

As shown in Table 8, revenues from capital taxes grew significantly during the 1980s. In 1986, they totalled roughly $1.3 billion; by 1990, they had risen to nearly $2 billion. Capital taxes now

**Table 8:** ***Provincial Revenue from Capital Taxes, 1986–90***

| | 1986 | 1987 | 1988 | 1989 | 1990 |
|---|---|---|---|---|---|
| | | | *($ thousands)* | | |
| Newfoundland | 1,887 | 2,269 | 2,803 | 3,660 | 5,344 |
| Prince Edward Island | 0 | 0 | 332 | 834 | 1,259 |
| Nova Scotia | 3,592 | 5,955 | 7,029 | 7,594 | 13,180 |
| New Brunswick | 0 | 2,703 | 6,388 | 8,448 | 9,005 |
| Quebec | 585,713 | 675,927 | 744,159 | 924,300 | 1,029,000 |
| Ontario | 515,913 | 542,769 | 568,714 | 687,115 | 665,285 |
| Manitoba | 39,924 | 57,428 | 59,830 | 72,822 | 73,452 |
| Saskatchewan | 42,751 | 53,609 | 71,858 | 96,211 | 115,579 |
| Alberta | 0 | 0 | 0 | 0 | 0 |
| British Columbia | 86,443 | 49,312 | 23,392 | 5,111 | 8,869 |
| *Total* | *1,276,223* | *1,389,972* | *1,484,505* | *1,806,095* | *1,920,973* |

Source: Statistics Canada, Public Institutions Division.

represent close to 30 percent of provincial CIT revenues. Quebec collects more than 50 percent of all capital tax revenues raised by the provinces. In fact, Quebec now collects more from capital taxes (about $1 billion) than from corporate income taxes (about $700 million).

## Efficiency

Capital, particularly financial capital, is arguably the most mobile factor of production across the provinces, and certainly more mobile than labor. Although many factors influence capital investment, recent studies on investment and taxation have suggested that taxes significantly reduce it.[3] It is thus expected that differences in effective tax rates on capital across provincial jurisdictions can have an impact on the allocation of capital. In other words, spillover effects of provincial tax policies pertaining to corporate and capital are expected to be quite important.

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[3] A review of econometric studies can be found in Jack M. Mintz and Douglas D. Purvis, *Taxation and Business Activity* (Kingston, Ont.: John Deutsch Institute for the Study of Economic Policy, 1987).

Provinces with TCAs naturally use a tax base similar to that of the federal government. However, the three provinces that collect their own corporate income tax also use an income tax base that is essentially similar to the federal base. It is hard to explain why this is so, except that the sheer dominance of the federal government in the collection of CIT revenues — it receives twice the amount collected by provinces) may inhibit provinces from straying too far from the its lead.

Nonetheless, there is some provincial variation in corporate tax policy, resulting, in part, from different statutory corporate tax rates, the use of capital taxes, and different allowances and incentives for certain industries. We examine the impact of corporate income and related tax provisions by measuring the effective tax rate — that is, the percentage of the return on capital that is taxed by federal and provincial governments on new investment.

The structure of effective tax rates,[4] which include corporate income, capital, and mining taxes — the latter will be discussed in greater detail under *Taxes on Natural Resources* — is presented in Table 9. The effective tax rates do vary by province: Manitoba's rates are highest for all industries except mining, and the Atlantic provinces' are the lowest.

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[4] The effective tax rate is the amount of taxes paid as a percentage of income earned for the capital project that is just profitable enough to attract savings from investors. The rate is a summary measure taking into account not only the statutory tax rate but also depreciation allowances, inventory cost deductions, investment tax credits, and resource writeoffs. For a more complete explanation of the concept, see Robin W. Boadway, Neil Bruce, and Jack M. Mintz, *Taxes on Capital Income in Canada: Analysis and Policy* (Toronto: Canadian Tax Foundation, 1987), chapters 1 and 2. The numbers presented in Table 9 also include capital and mining taxes. See R. Boadway, K. McKenzie, and J. Mintz, *Canadian Mining Taxes* (Kingston, Ont.: Queen's University, Centre for Resource Studies, 1989) for a discussion of mining taxes. Also, see D. Chen and J. Mintz, "Impact of Capital Taxes on the Structure of Investment" (University of Toronto, 1991, Mimeographed) for a derivation of effective tax rates on capital.

## Table 9: The Structure of Effective Corporate Tax Rates by Province, 1991

| Sector | Nfld. | P.E.I. | N.S.[a] | N.B. | Que. | Ont. | Man. | Sask.[b] | Alta.[c] | B.C. |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | *(percent)* | | | | | |
| Agriculture, fishing, forestry | | | | | | | | | | |
| Large business | 21.13 | 19.07 | 20.10 | 21.13 | 24.32 | 25.83 | 31.65 | 30.04 | 28.05 | 27.62 |
| Small business | 2.65 | 2.65 | 2.65 | 1.98 | 7.73 | 9.62 | 11.22 | 11.22 | 8.95 | 10.64 |
| Combined | 4.07 | 3.92 | 3.99 | 3.44 | 9.36 | 11.12 | 13.17 | 13.04 | 10.55 | 12.11 |
| Manufacturing | | | | | | | | | | |
| Large business | 24.04 | 21.82 | 23.12 | 24.43 | 30.28 | 31.84 | 38.67 | 36.88 | 34.45 | 33.96 |
| Small business | 4.71 | 4.71 | 4.71 | 3.54 | 13.37 | 16.30 | 18.81 | 18.81 | 15.30 | 17.92 |
| Combined | 22.04 | 19.77 | 20.90 | 21.88 | 28.48 | 30.12 | 36.49 | 34.92 | 32.14 | 32.07 |
| Construction | | | | | | | | | | |
| Large business | 47.49 | 45.32 | 46.41 | 47.49 | 42.25 | 49.14 | 51.40 | 49.53 | 47.79 | 47.28 |
| Small business | 23.56 | 23.56 | 23.56 | 22.44 | 18.33 | 25.09 | 25.09 | 25.00 | 20.77 | 24.02 |
| Combined | 32.65 | 31.83 | 32.24 | 31.97 | 27.98 | 34.50 | 35.61 | 34.85 | 31.03 | 32.82 |
| Transportation and storage | | | | | | | | | | |
| Large business | 15.47 | 13.74 | 14.60 | 15.47 | 19.23 | 22.68 | 25.08 | 23.70 | 20.56 | 20.18 |
| Small business | –1.77 | –1.77 | –1.77 | –1.96 | 1.12 | 2.09 | 2.09 | 2.09 | 1.42 | 1.91 |
| Combined | 10.97 | 9.64 | 10.30 | 10.87 | 15.82 | 18.67 | 20.74 | 19.67 | 16.34 | 16.32 |
| Communications | | | | | | | | | | |
| Large business | 15.60 | 14.27 | 14.93 | 15.60 | 14.12 | 16.75 | 18.98 | 17.78 | 14.68 | 14.36 |
| Small business | 0.22 | 0.22 | 0.22 | 0.07 | 0.48 | 1.23 | 1.23 | 1.23 | 0.70 | 1.08 |
| Combined | 15.14 | 13.86 | 14.49 | 15.13 | 13.77 | 16.33 | 18.52 | 17.36 | 14.24 | 13.96 |
| Public utilities | | | | | | | | | | |
| Large business | 16.15 | 14.76 | 15.44 | 16.15 | 14.92 | 17.93 | 20.10 | 18.85 | 16.03 | 15.69 |
| Small business | 9.96 | 9.96 | 9.96 | 9.38 | 7.54 | 10.97 | 10.97 | 10.97 | 8.74 | 10.40 |
| Combined | 15.49 | 14.14 | 14.81 | 15.48 | 14.40 | 17.30 | 19.43 | 18.22 | 15.38 | 15.08 |

Table 9 - *continued*

| Sector | Nfld. | P.E.I. | N.S.[a] | N.B. | Que. | Ont. | Man. | Sask.[b] | Alta.[c] | B.C. |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | *(percent)* | | | | | |
| Wholesale trade | | | | | | | | | | |
| Large business | 36.87 | 34.83 | 35.85 | 36.87 | 32.92 | 38.75 | 41.18 | 39.40 | 37.04 | 36.55 |
| Small business | 15.20 | 15.20 | 15.20 | 14.34 | 12.18 | 17.22 | 17.22 | 17.22 | 13.97 | 16.39 |
| Combined | 27.87 | 26.71 | 27.29 | 27.49 | 24.99 | 30.19 | 31.84 | 30.80 | 27.41 | 28.21 |
| Retail trade | | | | | | | | | | |
| Large business | 32.39 | 30.53 | 31.45 | 32.39 | 28.12 | 33.21 | 35.70 | 34.02 | 31.26 | 30.81 |
| Small business | 13.66 | 13.66 | 13.66 | 12.83 | 10.10 | 14.46 | 14.46 | 14.46 | 11.63 | 13.74 |
| Combined | 21.60 | 20.06 | 21.23 | 21.16 | 18.37 | 22.72 | 23.98 | 23.28 | 19.86 | 20.97 |
| Services | | | | | | | | | | |
| Large business | 20.32 | 18.62 | 19.46 | 20.32 | 20.08 | 24.16 | 26.41 | 24.95 | 22.36 | 21.97 |
| Small business | 4.44 | 4.43 | 4.43 | 3.88 | 6.24 | 9.23 | 9.24 | 9.25 | 7.30 | 8.73 |
| Combined | 10.07 | 9.56 | 9.61 | 9.68 | 11.77 | 14.74 | 15.74 | 15.26 | 12.31 | 13.26 |
| Mining | | | | | | | | | | |
| Large business | -88.87 | n.a. | -95.81 | -96.74 | -26.80 | -34.34 | -85.39 | 9.46 | -15.98 | -11.60 |
| Small business | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. | n.a. |
| Combined | -88.87 | n.a. | -95.81 | -96.74 | -26.80 | -34.34 | -85.39 | 9.46 | -15.98 | -11.60 |
| Aggregate | | | | | | | | | | |
| Large business | 6.23 | 23.94 | 24.52 | 12.36 | 24.58 | 28.23 | 27.46 | 24.52 | 20.59 | 23.93 |
| Small business | 9.81 | 8.11 | 10.13 | 9.66 | 10.00 | 13.81 | 13.51 | 12.88 | 11.98 | 13.73 |
| Combined | 5.36 | 16.49 | 19.49 | 10.26 | 21.05 | 24.55 | 22.98 | 19.94 | 16.90 | 20.67 |

[a] The aggregate number for Nova Scotia does not include the mining industry.

[b] The number for the mining industry in Saskatchewan, and hence the aggregate number for that province, does not incorporate certain recent mining taxation rules.

[c] The aggregate number for Alberta is probably far from accurate, because the oil and gas industry, which accounts for more than 50 percent of total capital stock in the province, has not been considered here.

Sources: Authors' calculations; and D. Chen and J. Mintz, "Impact of Capital Taxes on the Structure of Investment" (University of Toronto, 1991, Mimeographed).

As discussed in the preceding section, the provinces have introduced a number of provisions that help to create variations among effective tax rates. The most notable example is Quebec's significantly lower statutory rate on active business income and its substantial increase in capital taxes, introduced in 1981. Quebec consequently has lower effective tax rates than Ontario and the Western provinces — although its rates on capital are higher than those of the Atlantic provinces, particularly for agriculture, fishing, forestry, manufacturing, and transportation.

The significant advantage enjoyed by the Atlantic provinces arises from a regionally based federal incentive, not from provincial incentives: the federal government provides a 15 percent investment tax credit for expenditures on qualifying machinery and structures in the primary, manufacturing, and transportation industries. This is an example of how capital resource allocation across provinces is impeded more by regionally differentiated federal corporate tax policy than by provincial tax policy.

Nonetheless, despite federal policies, the efficient allocation of resources can be impaired by provincial variations in effective tax rates, compared with a situation of government coordination of effective tax rates. But this is not the only inefficiency induced by provincial variations in corporate tax rates. There are the spillover effects that are induced by governments pursuing their own interests. As discussed in Chapter 1, these spillover effects arise from the concern over tax-base sensitivity — thereby encouraging provinces to grant incentives to reduce capital flight from their jurisdiction — and tax exportation — thereby encouraging a government to increase corporate taxes if the burden is shared by other jurisdictions.

The changes in corporate taxation introduced by Quebec illustrate the importance of spillovers associated with tax-base sensitivity. Quebec's shift from the CIT to the capital tax was designed to guard the provincial tax-revenue base by reducing incentives to move corporate income out of the province. The same goal of protecting the revenue base was adopted by the federal government in the 1980s and is evident in its use of capital taxes on financial institutions and insurance companies, as well as in its "large corporation" tax. In order to raise more corporate tax revenues, the federal government chose the capital base rather than the income base, since the former is less vulnerable to tax-planning opportunities.

Tax-exportation spillovers have also arisen in the Canadian context. The provincial corporate income tax is an "add-on" tax, while other taxes, such as capital and payroll taxes, are deductible from the federal and provincial CIT base. The provinces have found that by shifting from CITs to taxes that are deductible from the federal corporate tax base, they can shift some of the provincial tax burden onto the federal government. In 1976, the federal government was sufficiently concerned with provincial increases in resource royalties that it disallowed their deduction in favor of a resource allowance — equal to 25 percent of resource profits. Similarly, the federal government proposed in its 1991 budget to eliminate the deductibility of provincial capital and payroll taxes and replace these deductions with a 6 percent reduction in the effective federal CIT rate. The federal government's main argument for this change is that there is a fiscal incentive for provinces to shift to taxes that are deductible from the federal corporate income.

Of course, as matter of symmetry, one could also argue that there is a similar incentive for the federal government to shift from corporate (and personal) income taxes to taxes that are deductible from provincial tax bases. In the past, federal payroll, capital, and sales taxes were deductible from the income tax base. The deductibility of these taxes reduced not only federal but also provincial CIT revenues. Although federal and provincial CITs have been harmonized to reduce spillover effects, there remains considerable latitude for provinces and the federal government to engage in tax exportation, since so many other corporate taxes are co-occupied and uncoordinated.

## Simplicity

Without doubt, the Tax Collection Agreements in seven provinces have eased the burden of corporate income taxation, especially for small businesses. Only one set of rules must be complied with and only one form completed. The provinces have also saved on administrative costs. In the three provinces without TCAs, administrative costs are borne separately by the two governments. The private sector's compliance costs in those provinces are less than might be expected, however, since the federal and provincial rules used to define the tax base are similar.

The same cannot be said about the costs of complying with capital taxes. Capital taxes are levied on assets valued according to a set of accounting rules at the federal level and tax rules at the provincial level — for example, in Ontario, shareholder reserves may be calculated in accordance with tax rules for the valuation of assets and income. Moreover, to the extent that provincial CIT bases differ, their capital tax bases will also differ. When a province varies its income tax base from the federal government's — as with the special treatment of research costs in Ontario — the valuation of assets begins to differ and it becomes more difficult to comply with the capital taxes operating in each province. The lack of coordination of capital taxes across provinces and between the federal and provincial governments could become a serious issue if the trend toward increased reliance on capital taxes continues.

The cost of compliance with the CIT and the capital tax is difficult to estimate. Studies in Canada have concentrated more on personal income tax compliance. Yet, it is corporate taxes that involve the highest compliance costs (as a percentage) of tax revenues, because of the amount of litigation and accounting that compliance with the system entails.

## Flexibility

The provinces have used the corporate income tax as a delivery mechanism for incentives given to business. A large number of specific provincial incentives have been available in the past decade. The following is not an exhaustive list:

- research and development (Ontario, Nova Scotia, and Quebec);
- manufacturing (Ontario, Quebec, Manitoba);
- venture capital or small business investment (Saskatchewan, Quebec, Ontario, and British Columbia);
- lower corporate tax rates for small business (all provinces except Prince Edward Island);
- corporate tax holidays (Saskatchewan, New Brunswick, and Ontario);
- depletion deductions (Quebec, Saskatchewan, and Ontario);
- employment tax credits (British Columbia); and
- oil and gas drilling incentives (Alberta).

The provincial tax incentives are policies that substitute for general expenditure grants. At times, tax incentives are used in preference to other government policies because it is administratively easier to implement them. There are at least three administrative reasons for the provision of tax incentives rather than grants.

First, tax incentives may be simpler to administer than grants, because the latter may require a longer time for application, approval, and implementation. A tax incentive can be given as long as the activity qualifies. Moreover, the amounts given can be claimed through a reduction in taxes paid as part of the income tax filing process.

Second, the government can provide refundable tax credits — for example, 40 percent of investment tax credits were made refundable for small businesses in the 1980s. Tax incentives can thus be used even if the firm does not pay taxes.

Third, if the government wants to limit the use of an incentive, it can, for example, require that the amount claimed be no more than a certain percentage of taxes due. Or, to help ensure that only profitable, taxpaying companies can use the credit, the government can make it nonrefundable — or limited by caps on the amount claimed relative to taxes paid. Nonrefundable tax incentives penalize startup companies and firms engaged in risky activity, while large, mature companies can take full advantages of them. By contrast, in an open economy, a nonrefundable incentive for a particular activity encourages companies to locate several complementary activities in Canada to take advantage of the full value of the incentive.[5]

There are also good reasons for governments to use expenditures rather than the tax system for business incentives. In the parliamentary system, accountability is facilitated with expenditures. In addition, it is easier to target grants than tax incentives. And finally, grants are automatically refundable, and therefore do not discriminate among companies of different tax status.

Depending on the tradeoffs involved, a provincial government would use either tax incentives or grants to encourage certain investment activities. As long as the constitutional division of powers allows provinces to encourage capital formation in their own jurisdiction, they will continue to use the CIT and capital taxes to complement expenditure policies in achieving this aim.

## Recommendations

On grounds of efficiency and simplicity, there is little to support the status quo — that is, that the provinces should have the corporate income tax and the capital tax as sources of revenue. Given the importance of spillover effects and the costs of administering the corporate tax, it would seem that, if any tax field is allocated to the federal government, it should be the corporate tax field. This conclusion is all the more compelling in a world that is quickly moving toward "globalization." International pressures are making it more difficult for governments to pursue uncoordinated corporate tax policies to ensure sufficient revenues for fiscal needs. At the international level, corporate tax revenues have declined significantly since 1965, although they did stabilize, and in some cases increased, during the 1980s.[6] It is unlikely that the provinces will be any more successful than the federal government in withstanding these international pressures on their revenues.

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[5] For example, research and development incentives are more generous in Canada than those in the United States. Some companies have consequently found it lucrative to keep both manufacturing and research activities in Canada, rather than moving manufacturing south of the border, since they can make full use of the R&D incentives that way.

Suppose that the federal government were responsible for the corporate income tax and the federal and provincial governments shared the personal income tax. What arguments could be made to suggest that, instead, the federal and provincial governments should co-occupy the corporate and personal income tax fields?

The first deals with integration. The CIT is a backstop for the personal income tax — that is, without the CIT, taxpayers could avoid personal taxes on capital income by leaving their income in a corporation. Canada has followed the route of integrating corporate and personal taxes by providing dividend tax credits, exempt treatment of intercorporate dividends, and partial exclusion of capital gain income. When the federal and provincial personal and corporate income taxes are harmonized in terms of the tax base, integration works relatively well in Canada. In each province, integration operates to equalize tax rates on different sources of income, as the provincial governments impose personal taxes on federal tax payable and corporate taxes on taxable income. Thus, the federal government, by equalizing federal tax rates on sources of income, also roughly equalizes provincial tax rates. However, if the federal government alone imposed corporate income taxes, while both the federal and the provincial governments imposed personal taxes, difficulties in integration would likely arise. Harmonization of the treatment of capital income under the personal income tax at the federal and provincial levels would still continue. CIT rates that currently vary by province would no longer differ, since only the federal government would collect the tax. However, to preserve integration, the corporate tax rate would have to be set so that corporate and personal taxes were integrated for some reference rate of a combined federal and provincial personal income tax rate — for example, the highest marginal personal tax rate for a selected province such as Ontario or some combination of provinces.

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[6] See Organisation for Economic Co-operation and Development, "Capital Income Taxes in a Liberalized Financial Environment"(Working paper, Paris, 1991).

A second argument in favor of some provincial involvement in the CIT is that provinces would have the flexibility to use the tax system or expenditures to conduct industrial and development policies. As argued earlier, there are some practical reasons for using tax incentives: without the CIT, the provinces could rely only on grants to encourage certain corporate activities in their jurisdiction.

Neither of the above reasons for leaving corporate tax at the provincial level is particularly compelling. There is an economic cost to Canada as a whole when provinces use policies that interfere with the efficient allocation of capital across provincial borders. If, as part of a policy to enhance the Canadian economic union, the provinces should be prevented from using capital incentives, then it is inappropriate for them to be using corporate tax incentives to encourage capital formation in their own jurisdiction. Flexibility under the corporate tax for the provinces is therefore not a goal for constitutional reform if governments wish to achieve a free flow of capital across provincial borders.[7]

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[7] Of course, this also applies to the federal government, which uses investment tax credits to encourage capital formation in slow-growth regions — a measure that interferes with the efficient allocation of capital resources in the federation.

## Chapter 7

# *Taxes on Natural Resources*

## Structure

The constitutional amendments of 1982 affirmed the right of the provinces to own the natural resources existing within their boundaries. They also recognized the right of the provinces to tax the earnings that accrue to Crown property situated in their jurisdiction.

Over the years, the provinces have developed a set of complicated mining, forestry, and oil and natural gas taxes intended to exact rents from the ownership of Crown lands. The basic elements of the tax regimes are as follows.

### *Mining Taxes*

Mining taxes vary considerably across provinces (and territories) in terms of both rates and base. In fact, some provinces, particularly Saskatchewan, use more than one type of tax regime. Some of the variants include the following:

### Gross Profit Taxes

All provinces except British Columbia and Saskatchewan apply taxes to gross profit — defined as revenue net of current costs, depreciation, development, and exploration expenses. Interest, depletion, and royalties are not deductible. There is significant variation among the eight provinces in permitted deductions, as the following examples illustrate:

- Mining assets are depreciated at rates varying between 10 percent (Newfoundland) and a maximum of 100 percent (Nova Scotia and New Brunswick).
- Processing assets are treated liberally, earning fast writeoffs for depreciation in some provinces. Special allowances equal to a percentage of the original cost of the asset are granted in all eight provinces.
- Preproduction assets are depreciated as mining assets in Manitoba, Nova Scotia, and Newfoundland, but are expensed in Alberta, Ontario, Quebec, and New Brunswick.
- Exploration expenditure is expensed in all provinces except Nova Scotia (where it is deductible from taxable income at a rate of 150 percent), Quebec (deductible at a rate of 133 percent), and Newfoundland (where it is depreciable).

Other variations in mining profit taxes include different allowances for carryback and carryforward of losses, varying research and development incentives, and differing treatments of overhead taxes.

## Cash Flow Taxes

British Columbia mining and Saskatchewan uranium and potash are subject to a form of cash flow tax. Cash flow taxes apply to the revenues of the mine net of current and capital expenditures. There is a carryforward of unused capital expense deduction, usually at an imputed rate of interest. The British Columbia and Saskatchewan taxes contain few other incentives except for an exploration tax credit and a progressive rate of tax in Saskatchewan.

## Graduated Rate Structures

Several provinces have graduated rate structures, meaning that the mining tax rate increases with profit. Graduated structures are in place in Saskatchewan — based on profit per kilogram of output — Newfoundland, Quebec, and New Brunswick. In the latter three cases, the mining firm is taxed higher on profits in excess of some specified minimum.

### Minimum Taxes

Saskatchewan, British Columbia, Alberta, New Brunswick, and Nova Scotia require payment of a minimum level of tax, which may or may not be creditable against the mining tax.

### *Oil and Gas*

Provinces also use different rules for taxing oil and gas. In general, the provinces all impose royalties — calculated as a percentage of revenues or as a dollar payment per unit of production — but there is considerable variation in the methods used to assess them. Most of the provinces vary the royalty rate according to production levels, some according to price and production levels (for example, Alberta), and some according to the proportion of newly discovered mineral deposits (for example, Saskatchewan, Alberta, and British Columbia). Also, Nova Scotia has an additional tax applying to net revenue.

Provincial oil and gas taxes also include a number of special incentives, which are of two types: tax holidays and royalty tax credits.

### *Forestry*

Provinces collect payments for rights to exploit forested lands. In addition, most impose stumpage duties, which often vary according to the quality of the product. Quebec and British Columbia also impose a logging profits tax.

## Efficiency

Although the preceding brief description of resource taxes masks the considerable variation in the terms and conditions of taxes faced by resource producers in Canada, it is clear that if there is a tax jungle in this country, it is in the area of resource taxation.

Table 9 (in Chapter 6), on effective tax rates, confirms that there is a great deal of variation by province in effective corporate tax rates for mining. This variation is made even greater by the different treatment of assets across provinces: exploration and processing expenditures are highly encouraged by some provincial tax regimes.[1]

In fact, most provincial mining taxes are poor collectors of rents. (The negative values of the effective tax rates for mining in Table 9 suggest that the generous tax deductions reduce taxes owing on inframarginal returns on mining.) Only in the case of British Columbia, which resorts to a cash flow tax, does the mining tax properly apply to rents without distorting investment and financing decisions.[2] By contrast, oil and gas royalties lead to heavy taxation of these industries relative to other industries.[3] The provinces, particularly Alberta, have not only taxed away rents but have also significantly deterred investment in most activities except exploration.

One might take the view that, because the resources themselves are not mobile, any variation across provinces in effective tax rates cannot affect the efficient allocation of resource extraction. This logic, however, does not hold.

First, the very decision to extract a resource *over time* depends on the tax regime. There is considerable variation by province in effective tax rates on the extraction of resources, which can be explained as follows. When a firm extracts its ore at a later time, rather than currently, it gives up any potential after-tax interest earnings on funds generated by sales of the ore. Thus, in provinces with higher corporate and mining tax rates, firms are effectively encouraged to extract resources at a later time.

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[1] See Robin Boadway et al., "Marginal Effective Tax Rates for Mining in Canada," *Canadian Journal of Economics* 20 (1984): 1–16, and R. Boadway, K. McKenzie, and J. Mintz, *The Taxation of Mining Firms in Canada* (Kingston, Ont.: Queen's University, Centre for Resource Studies, 1990).

[2] Rents are returns in excess of the return needed to compensate owners of capital sufficiently to prevent them from investing funds in alternative projects. A cash flow tax applies to income net of current and capital expenditures, with no deduction for interest. This is equivalent to a rent tax that imputes the true cost of depreciation and financing costs.

[3] See Robin Boadway and Ken McKenzie, "The Treatment of Resource Industries," in J. Mintz and J. Whalley, eds., *Economic Impacts of Tax Reform* (Toronto: Canadian Tax Foundation, 1989), pp. 286–325. According to their calculations, the postreform effective tax rate on oil and gas varies from 62 percent in Saskatchewan to 84 percent, in Alberta. These effective tax rates are much higher than for any other industry.

Second, the choice between exploration and development activity and processing is affected by the tax system. Most provinces are quite generous in their tax incentives for the processing of mine ore, and the rate of subsidy varies across provinces. In fact, many are concerned about giving up their processing allowances, as they are worried about losing production to other provinces or to competing countries.

Third, there is an incentive to tax certain mineral products if the province has a "monopoly" in world markets. Saskatchewan, for example, has placed a levy on potash revenues, knowing full well that it forces up the world price for potash. This policy is in the interest of Saskatchewan, but not of the potash-using provinces of Canada.

## Simplicity

The highly complex and uncoordinated resource tax systems of the provinces make it difficult for producers to analyze the impact of those systems on their production systems. The rates of tax, the tax bases, graduated rate structures, and minimum taxation all contribute to complexity.

The provinces are not the only ones at fault. In the past decade, the federal government has used special rules under the corporate income tax for writeoffs for resource firms, including a resource allowance in lieu of provincial royalty deductions, earned depletion (no longer in place), and flow-through shares for exploration and development expenses. These rules only add to the complexity of resource taxation.

Moreover, there are special tax rules at both the federal and the provincial levels for megaprojects such as those relating to the tar sands, heavy oil, offshore oil and gas, and the exploitation of resources in northern territories. Complexity has only been increased by special treatment.

## Recommendations

Like the corporate income tax and the capital tax, efficiency and simplicity considerations point strongly to the need to reallocate resource taxes from the provincial to the federal level. But since the provinces *own* the natural resources within their boundaries, such a reallocation of the tax base is unlikely.

Nonetheless, the issues raised above suggest that there is a need for harmonization in this tax field. At the very least, cooperation should be fostered among the provinces to reduce spillovers arising from their uncoordinated tax policies. This cooperation could take the form of provincial meetings focusing on ways to coordinate tax policies in this area.

A stronger set of recommendations would include consideration of a constitutional amendment restricting tax powers in this field. If the provinces followed British Columbia's initiative in imposing a cash flow tax, there would be little need to harmonize resource taxation, since cash flow taxes, equivalent to true rent taxes, have little impact on the decisions of resource firms. It would be difficult, however, for constitutional reasons, to limit the provinces to such a narrow form of taxation by agreement.

# Chapter 8

# *Taxes on Consumption*

Federal and provincial governments have several types of consumption taxes, and there is little harmonization between the two levels.

The federal government levies its taxes under the *Excise Tax Act* — the goods and services tax (GST), special taxes on fuel, tobacco products, wine, jewelry, and automotive air conditioners; the *Excise Act* — duties on spirits, beer, and tobacco products; and the customs tariff. It also levies an air transportation tax, which is one of the few instances in Canada of a user fee.

Provincial governments levy taxes on general retail sales under either their retail sales tax (RST) acts or other, variously named, provincial sales tax acts. All provinces also have a variety of special taxes. For example, some provinces tax certain types of consumption, such as restaurant meals, hotel accommodation, and spectacle admission tickets, under legislation that is separate from their RST acts. For the sake of simplicity and because the impact of these taxes on revenues is relatively small, we include our discussion of them in the section on general sales taxes.

All provinces tax gasoline and other motive fuels under some type of fuel tax act. Eight of the provinces tax tobacco under a tobacco tax act, but Nova Scotia and Prince Edward Island tax it under a health tax act. Alcohol is taxed primarily through provincially controlled liquor sales, although some provinces levy a higher-than-standard RST on alcohol. In this chapter, we treat taxes on fuel, tobacco, and alcohol separately, following our discussion of general sales taxes.

# General Sales Taxes

## Structure

The federal government's GST, unlike the manufacturers' sales tax it replaced, is broadly based, although there are important goods that are "tax free" — basic groceries and medical supplies, for example. There are also certain goods and services that are provided by "exempt" producers; the producer does not need to charge a tax on goods and services supplied to consumers but, equally, cannot claim a refund for any GST paid on purchases from other businesses. Exempt goods include rental housing, education, and financial services. The general rate is 7 percent, but the effective rate on most new residential construction — because of the rebates on low- to moderately priced new housing — is only 4.5 percent.

All provinces except Alberta levy a general RST, supplemented in some provinces by special taxes on, for example, meals, lodgings, and amusements. Although each of the nine provinces has developed an RST structure that is really quite individual, there are more similarities than variations among them. There is a standard RST rate in each province covering the majority of the taxed sales, with different (usually higher) rates (or separate legislation) for a few categories in many provinces (for example, alcoholic beverages and entertainment).

The range of goods and services that are subject to tax share many common elements. Sales taxes have traditionally targeted tangible personal property, with universal exemptions including food (other than candy and soft drinks), children's clothing, and prescription medicines. A limited number of services have also been taxed. For example, all provinces, including Alberta, have taxed race-track betting for some time. (Quebec is alone, however, in imposing a tax on prizes.) Telephone and telecommunication services are subject to tax in most provinces, as are prepared meals and transient accommodation.

Although each province has its own list of exemptions from the general list of personal-use goods, the trend has been for the variations to multiply in the extension of the tax to personal and business services.[1] The labor for installation of, or repairs to, tangible property and cable television services is taxed in some provinces. Manitoba and Saskatchewan tax photocopying, nonresidential use of electricity, and computer services. Newfoundland and Quebec tax broadcast advertising. In the aggregate, however, the provinces had expanded their sales taxes to quite a variety of services before the GST was introduced — unlike the federal government, which had made only a narrow assault on service sector sales.

Before the GST was implemented in 1991, Quebec announced it would "harmonize" its tax with the federal government's. Its plan was to complete the integration in two stages. Stage 1, when the base was broadened to include all movable goods, took place in 1991. Implementation of Stage 2 was originally set for January 1, 1992, but was subsequently postponed for six months. The tax is to be extended to services and real property (almost matching the GST base), with Quebec collecting both the federal and the Quebec portions, and the federal government reimbursing Quebec for the cost of collecting the GST.[2] The provincial sales taxes paid on purchases made as part of a business activity are to be refunded. Purchases made exclusively for resale purposes (for example, a retailer's inventory) and components of a movable good for subsequent sale are exempted from the Quebec sales tax. (This method, which is different from the federal GST's "invoice-credit" system whereby producers pay GST on purchases from other firms but also claim a credit, has been adopted by Quebec because it fears that it does not have the constitutional right to collect its own tax that applies to intermediate stages of production.) This will make the harmonization between the federal and the provincial levels in Stage 2 more difficult, since the tax bases are quite dissimilar. The Quebec experience underlines the complications that arise when a province becomes the collector of the harmonized GST. When Saskatchewan planned a GST, it avoided this problem by ceding the collection to the federal government.

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[1] See J. Harvey Perry, *Taxation in Canada* (Toronto: Canadian Tax Foundation, 1989), ch. 15; and Canadian Tax Foundation, *Provincial and Municipal Finances* (Toronto, 1989), pp. 10.3–10.8, for more details.

[2] The effect of Quebec's base broadening was not immediately obvious at the time of the government's initial statement in August 1990. For example, in July 1991, Quebec announced that, after January 1, 1992, it would begin to tax all air, bus, and rail travel originating in Quebec and ending in any part of Canada and, furthermore, that the base of the tax would include the federal air transportation tax and the GST.

## Efficiency

The federal and provincial sales taxes are equally vulnerable to successful lobbying for exemptions or special treatment.[3] The federal GST is far more encompassing than any of the provincial RSTs and, therefore, more even in its application to goods and services.[4] The combination of the inclusion of many business inputs under the RST umbrella and the exclusion of many consumer goods and most services has resulted in the provincial tax's amounting to varying proportions of the final selling price of all consumer goods and services. Exemptions and the taxation of business inputs distort both producer and consumer choice, limiting the potential neutrality of sales taxes.

The RST is supposed to satisfy the legal interpretation of the constitutional restriction of the provinces to direct taxes by being applied at the final point of sale in order to avoid tax exportation. But it is easier to establish the principle of taxing only the final consumer than it is to put the principle into practice. Under the RST, the taxation of business inputs — especially promotion and travel, office supplies, and transport goods — is widespread, with no suspension of the tax, or any widespread mechanism for refunding it, on business purchases. Furthermore, goods or services used in the production process have sometimes been deliberately targeted, as in the case of many business services, which have been a major source of revenue growth for the provinces.[5] An example of deliberate taxation of business inputs is Saskatchewan's taxation of nonresidential electricity while residential use is exempted; a similar situation exists in British Columbia with respect to local telephone service. Since taxes that are initially levied on intermediate goods are ultimately borne by factor incomes, they are an indirect form of taxation. To the extent that the ultimate payer of the tax resides outside the taxing province, RST levies on intermediate goods and services are in violation of the spirit, if not the letter, of the Canadian Constitution.

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[3] Some examples of successful pressure groups in the designing of RSTs are farmers, textile manufacturers, and the road transport sector. See A.J. Robinson, *The Retail Sales Tax in Canada* (Toronto: Canadian Tax Foundation, 1986), p. 67.

[4] It is unclear whether the GST is more "efficient" than other sales taxes. The literature has argued for nonuniform sales taxes on the grounds that some goods, such as leisure, are not taxable. It is appropriate to tax more highly those taxable goods that are consumed with nontaxable items. For example, if leisure is untaxed, then it is efficient to tax goods such as pleasure travel more highly.

The provinces' conflict between revenue needs and efficiency — rather than the limitations of the RST *per se* — makes them reluctant to eliminate the taxation of business inputs. A study by Statistics Canada revealed that 34.4 percent of RST revenue was borne by business in 1984.[6] Although the range in the incidence across the country was large — from 28.8 percent in Prince Edward Island to 42 percent in British Columbia — the distortion was serious in all provinces.[7] This flaw has, as in the case of the former federal sales tax, a negative effect on Canadian exports and import-competing industries through cascading — that is, the application of the same tax rate at more than one stage of production of the same item — which produces different effective rates for different items. Alberta business, because the province has no RST, has always had a natural advantage over the other provinces in this respect. If Quebec

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[5] Robinson, *The Retail Sales Tax in Canada*, p. 88.

[6] Statistics Canada, *Canadian Economic Observer*, September 1989, p. 4.4.

[7] Saskatchewan was 40 percent; Nova Scotia, 36 percent; and five provinces fell into the relatively narrow range of 32 percent to 34 percent (Statistics Canada, *Canadian Economic Observer*, May 1989, p. 3.15).

**Table 10:** ***Statutory and Effective Retail Sales Tax Rates by Province***

| | Statutory Rate, 1989 | Adjusted Statutory Rate, 1991 | Effective Rate, 1989 |
|---|---|---|---|
| | | *(percent)* | |
| Newfoundland[a] | 12.00 | 12.84 | 15.20 |
| Prince Edward Island[a] | 10.00 | 10.70 | 12.70 |
| Nova Scotia[a] | 10.00 | 10.70 | 10.70 |
| New Brunswick[a] | 11.00 | 11.80 | 12.30 |
| Quebec[a] | 9.00 | 8.60 | 9.80 |
| Ontario | 8.00 | 8.00 | 10.50 |
| Manitoba | 7.00 | 7.00 | 9.80 |
| Saskatchewan | 7.00 | 7.00 | 9.00 |
| British Columbia | 6.00 | 6.00 | 8.10 |

[a] The adjusted statutory rate in 1991 includes the retail sales tax on the GST where the GST is included in the base. Quebec's statutory rate for 1991 was 8 percent.

Note: The effective rate in 1989 is derived by dividing the tax collected by personal expenditure on consumer goods and on those services that most provinces tax.

Sources: Effective rates are authors' calculations based on Statistics Canada, *National Income and Expenditure Accounts*; and idem, *Provincial Economic Accounts*.

goes ahead with its GST in 1992, it will also have an advantage until most provinces follow suit.

The revenue from the taxation of business inputs appears to overwhelm the loss from the various exemptions (including food), since the sales tax revenue as a percentage of personal expenditures on consumer goods and of taxable services (an "effective" rate) is higher in all provinces than the statutory rate, as Table 10 shows. Where the differences are smaller than average, the reason could be either more exemptions or more business inclusions than average. In the case of Quebec, the explanation lies in the generous exemptions (cancelled in 1991) of furniture and other household effects, most shoes, clothing, and textiles. These exemptions also produced one of the lowest effective rates in the country, although its statutory rate was higher than that of four other provinces.

There is no reason, however, why the RST should not be broadly based and limited to final domestic purchases, since the GST and RST are, in principle, equivalent taxes at the point of final sale to the consumer. The fact that the provinces discriminate heavily in favor of most services is not a reason to advocate a value-added-type tax like the GST to replace the RSTs. The real difference between the two taxes pertains to the method of collection. The RST exempts producers by the "suspension" method: a producer shows an exemption certificate to avoid taxes on business inputs. The GST uses the "invoice-credit" method described earlier: producers pay GST on purchases from other firms but later claim a credit. There is an unproved belief that the invoice-credit method works better in reducing tax evasion, because it leaves a "trail of paper" to audit receipts. However, since it is much easier for the private sector to comply with the suspension method, that method could still be used for many goods and services that are not consumed by households, such as industrial machinery and engineering services.

For geographical reasons, provincial governments are probably more vulnerable to competition from sales tax rates in neighboring U.S. states than from lower rates in neighboring provinces (see Figure 1). But significant competition among provinces does exist in particular areas. Perhaps the most exposed communities are those in British Columbia that have easy access to Alberta cities and towns. Thus, British Columbia must take Alberta's zero rate into account when setting its own rate. There are a number of other examples of such competition: Hull and Ottawa; Lloydminster on the Saskatchewan-Alberta border; Newfoundland's Labrador-Quebec border area.[8] The history of the various RST changes lends more credence to the idea that provinces seek opportunities to raise their rates or broaden their bases than to the notion that they fear the loss of revenue due to lower rates or greater exemptions in other provinces. For example, from 1971 to 1981 New Brunswick's rate matched Quebec's (8 percent). In 1976, Nova Scotia's rate went from 7 percent

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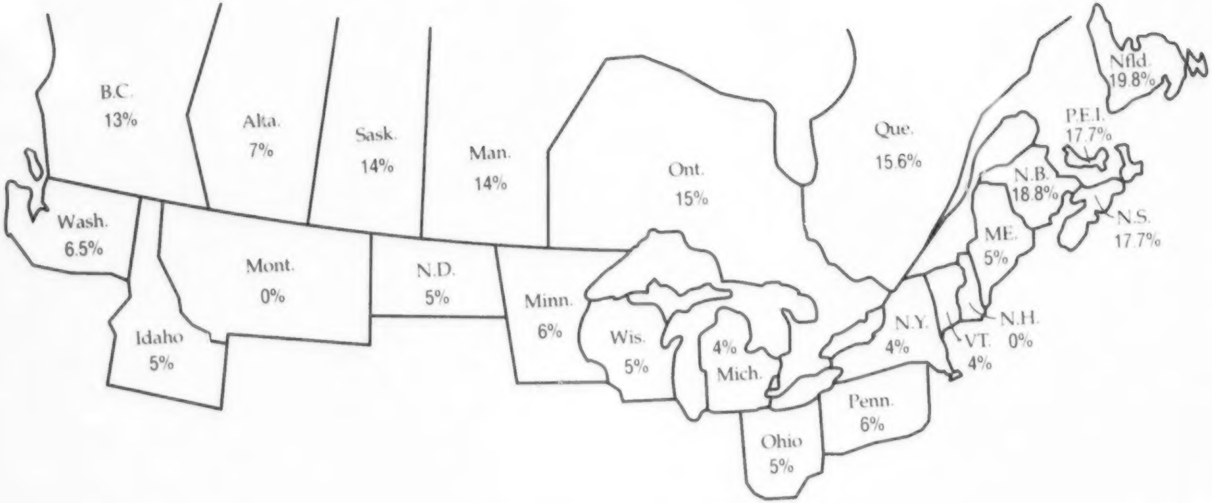
[8] Adult clothing was exempted from the RST in 1984 in the Labrador-Quebec border region.

**Figure 1:** ***Canadian and U.S. Sales Tax Rates: A Crossborder Comparison***[a]


B.C.
13%
Alta.
7%
Sask.
14%
Man.
14%
Ont.
15%
Que.
15.6%
Nfld.
19.8%
P.E.I.
17.7%
N.B.
18.8%
N.S.
17.7%
Wash.
6.5%
Idaho
5%
Mont.
0%
N.D.
5%
Minn.
6%
Wis.
5%
4%
Mich.
Ohio
5%
Penn.
6%
N.Y.
4%
VT.
4%
N.H.
0%
ME.
5%

[a] In Canada, the rate is the combination of the provincial sales tax, if any, and the federal goods and services tax. In the United States, the rate is the state sales tax; the United States does not have a federal sales tax.

Source: Jack Mintz and Tom Wilson, "Value-Added Taxes and the Goods and Services Tax: A Reply to Prof. Richard Bird," Reply factum of the Attorney General of Alberta, Case no. 12116, Court of Appeal of Alberta, February 19, 1991.

to 8 percent. Then, when Nova Scotia raised its rate to 10 percent in 1983, New Brunswick immediately followed suit.

The provinces have harmonized their RST systems to enhance their revenues in other ways. Quebec and the Atlantic provinces levy their RSTs on the GST. In 1984, only three provinces levied their RST on the price of tobacco products inclusive of their special tobacco tax, but by 1991, seven did so. For the most part without any formal agreement or forum, the nine provinces have produced RST systems with more similarities than differences in the lists of items taxed. An extension of the RST to new items by one province has invariably been followed by one or more provinces, whereas an exemption is only rarely copied.

Historically, there was no harmonization between the federal and the provincial sales tax systems — except for federal and provincial taxation of telecommunications. When the federal government tackled reform of its sales tax in 1987, it appeared to favor the option of a "national sales tax," which would have applied to a common federal and provincial base for all participating provinces. Although there seemed to be grounds for hope that such a sales tax would be acceptable to most of the provinces, negotiations came to an abrupt halt in early 1989, when the federal government withdrew from the talks, saying that it would proceed on its own. The resulting federal GST was decidedly a second-best solution. Nevertheless, Ottawa's intervention in the retail sales tax field, with a far broader base than that of any of the provinces' RSTs and the complete elimination of taxation of business inputs and capital, might prod the provinces to reform their sales taxes along the lines of the GST — but if it does not, the administrative chaos of running two separate taxes will continue. If the provinces eventually harmonize sales tax regimes with the federal GST, a large portion of provincial revenue will become subject to a Tax Collection Agreement. This will circumscribe provincial independence in tax policy considerably. It is hoped that the provinces will not, as a result, seek more independent powers in other tax fields, including the income tax. We believe, however, that this might be the eventual result.

Adding the GST, at 7 percent, to the provincial RSTs has resulted in a set of final sales tax rates ranging from 7 percent to 19.8 percent, compared with 0 percent to 6.5 percent in adjacent U.S. states (see Figure 1). The appreciation of the Canadian dollar since 1986 and increases in the RSTs and in the differentials between Canadian and U.S. tobacco and gasoline excise taxes were already providing a big incentive for crossborder shopping before the implementation of the GST — in fact, on many goods, the GST was no higher than the manufacturers' sales tax it replaced. It is the overall increase in combined federal-provincial sales taxes over the past few years that has exacerbated the problem of "free riding." The problem is particularly severe for the provincial governments, since Ottawa will not collect the RST at border crossings unless the province has partially harmonized its system with the GST. The federal government modified its condition from full harmonization to the harmonization of goods only in February 1992, as a strong inducement for the provinces to make the first move toward a federal-provincial GST. The response by the provinces, however, has been lukewarm.

## Simplicity

There are many problems associated with the studies that have been done on the administrative and compliance costs of general sales taxes.[9] Sandford, Godwin, and Hardwick found that, in the United Kingdom, the administrative costs of the value-added tax (VAT) as a percentage of VAT revenues dropped by half between fiscal years 1977/78 and 1986/87. They attribute this to various developments, including the change from two rates to a single higher rate, the extension of standard rates to previously zero-rated outputs, and the general growth in revenues from the tax.[10] It is for such reasons that Alan Tait points out the danger in relating the costs of administration to the revenues collected, although their broad movements over time as well as comparisons of their ratios with those of other taxes are informative. It is useful to keep one of Tait's conclusions in mind when considering the allocation question — namely, that a VAT can be justified only if it is a major revenue source, because of the economies of scale associated with its collection.[11]

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[9] See Cedric Sandford, Michael Godwin, and Peter Hardwick, *Administrative and Compliance Costs of Taxation* (Bath: Fiscal Publications, 1989), pp. 131–135, for a discussion of the various international studies available.

[10] Ibid., pp. 112–114.

Sandford and colleagues found that compliance costs in the United Kingdom also fell in real terms between fiscal years 1977/78 and 1986/87 due to such factors as the simplification of the rate structure and administerial procedures and some further learning effects.[12] Other evidence, however, suggested to the authors that compliance costs had begun to increase around 1986. Another important finding that confirmed the evidence of various international studies was that compliance costs are very regressive in their impact.[13]

There are fewer studies of the operation costs of retail sales taxes, but those that are available suggest that RSTs may not be much cheaper — as a percentage of revenues — than VAT-type taxes, since they are assessed at lower rates.[14] In the Atlantic provinces, however, RST rates are in double digits and, in most provinces, compliance costs are not inflated by heavy litigation.

What is apparent from the various sources is that both the administrative and compliance costs of general sales taxes are heavily influenced by the number and level of rates and exemptions involved, the size of the jurisdiction, and the complexity of the structure. In Canada, the GST is unnecessarily costly to administer and to comply with because of its complicated structure — and the cost would rise significantly if it were administered by the provinces because of the economies of scale associated with its collection.[15] A reformed RST would likely be cheaper to operate than a GST at either level.

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[11] Alan A. Tait, *Value Added Tax: International Practice and Problems* (Washington, D.C.: International Monetary Fund, 1988), pp. 268–269.

[12] Sandford, Godwin, and Hardwick, *Administrative and Compliance Costs*, pp. 123.

[13] Ibid., pp. 113, 130, 132, 135.

[14] Tait, *Value Added Tax*, p. 354.

[15] See Samuel Slutsky, "Life under GST May Get Scary Once Tax Assessments Begin," *Financial Post*, October 30, 1991, p. 16.

## Accountability

Superficially, the operation of the RST appears to be very transparent, since it is an extremely visible tax that is levied at the point of sale. However, the practice of a number of provinces of charging their RSTs on top of both other provincial taxes and the federal GST means that the statutory rate underestimates the full direct impact of the tax. Table 10 shows the effect of including the GST in the tax base. Furthermore, the true extent of the burden on consumers can be estimated only if the tax on intermediate goods is also factored in, as illustrated by the effective tax rate in Table 10.

Although the revenue from the RST is added to general revenues, some provinces have made a loose connection with a particular spending function in an attempt to improve accountability. For example, in Saskatchewan, the tax is called the education and health tax, and in British Columbia, the social service tax. This type of link is far too tenuous to either increase taxpayers' awareness of the costs of a particular program or influence demand.

## Equity

There is no unanimity among economists that sales taxes are regressive. Most now accept the notion that sales tax as a proportion of lifetime income is independent of income levels as long as all goods and services are taxed at the same rate. But, in practice, many goods are exempt. For example, the exemption of food makes the tax more progressive, while the exemption of bequests and leisure could make it regressive. As Bob Hamilton and John Whalley suggest, most of the exemptions, except that of food, do little to improve the distributive effect of the sales tax, for if the poor choose to spend on items that are not exempt, they suffer a tax penalty, yet the rich are free to benefit from items that are exempt.[16] The true incidence of the sales taxes is now debatable, although the public still perceives them to be regressive.

To counter the perceived regressivity of their sales taxes, provincial governments have exempted goods that might be termed "family essentials." Saskatchewan pursued this path farther than any other province. Between 1982 and 1987, the province's Conservative government increased the number of exemptions — clothing, restaurant meals, and most utilities — until the loss of revenue became insupportable,[17] and was subsequently able to get rid of these embarrassing exemptions in 1991 as part of Stage 1 of its plan to harmonize its sales tax with the GST. Saskatchewan's current NDP administration reversed this move when it cancelled plans for harmonization.

Quebec gave a vivid illustration of the perverse effects of pursuing equity through tax exemptions in its statement on the reform of its consumption taxes. Using clothing and shoes — the largest exemption in Quebec — as an example, it showed that the government would have lost $540 million in 1991 if it had continued the exemption, whereas the cost of using a tax credit to protect only those families with incomes under $31,500 would have been only $87 million.[18]

In fact, sales tax credits are not only less costly in terms of revenue, they are also more appropriate for increasing vertical equity. Although the federal government has used such credits in recent years, only a few of the provinces have adopted them. Currently, Quebec, Ontario, and Saskatchewan give a sales tax credit.

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[16] See Bob Hamilton and John Whalley, "Efficiency and Distributive Effects of the Tax Reform Package," in Jack Mintz and John Whalley, eds., *Economic Impacts of Tax Reform* (Toronto: Canadian Tax Foundation, 1989).

[17] Plagued by chronic, large deficits, the Saskatchewan government could ill afford the $200 million cost to the treasury in 1990 (Saskatchewan, Budget Address, 1990, p. 26).

[18] Québec, Ministère des Finances, *Appendix to the Minister's Statement concerning the Administration of the GST and the Reform of Consumption Taxes in Québec*, 1990, p. 33.

## Recommendations

In spite of the federal government's constitutional power of taxation, there has been a long-standing belief that the retail sales tax field belongs to the provinces. With its adoption of the GST, the federal government pushed the federal sales tax to the retail level -- a move that was broadly interpreted as usurping the provinces' rights.[19] Alberta, supported by Ontario and British Columbia, challenged the federal government's move in the courts on the grounds that collection of the tax before the final sale to the consumer interferes with property and civil rights and is therefore unconstitutional. The Supreme Court of Alberta has rejected this argument, although it did rule that the federal government must reimburse Alberta for the cost of collecting the tax.

The provinces should be more concerned by the fact that, as long as the federal government remains in the retail sales tax field, it will dominate the structure. With its supremacy in the structures of both the personal and the corporate income tax, there is a lopsided sharing of responsibility and power. If the federal government intends to retain its present control over the income taxes, it should leave the control of the retail sales tax field to the provinces. At the same time, however, Ottawa's access to this field has begun to push the entire tax structure to become more efficient. It is highly unlikely that, in the absence of competition from the federal government, Quebec would have moved to eliminate the exemptions on goods so quickly or would have introduced a plan to extend its sales tax to most services and to refund taxes on business purchases. In order to prod the other provinces into making their RSTs more efficient, the federal government should tighten up the constitutional prohibition on indirect taxation by provinces to include the business inputs that are now being taxed under the RST. This could be done by ensuring that provincial taxes paid on business inputs are refunded.

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[19] Quebec called the GST a "massive incursion into the sales tax field" (Quebec, Budget Address, 1990–91, p. 11). (It has not resolved the problem by taking over the administration of the tax.) Newfoundland complained that "the Federal Government will be invading the tax room traditionally occupied by the Province in our most productive tax base" (Newfoundland, Budget Address, 1989, p. 17).

The real problem to be resolved, however, is that Canada now has two separate sales tax systems in eight provinces, which has created an administrative nightmare, not to mention excessive compliance costs. Ideally, there would be one broad-based sales tax levied by one level of government, which would also exempt business inputs. Although operating costs would be minimized with a single general sales tax at the federal level, a single broad-based general sales tax at the provincial level would be less costly than the combined system that we now have. As long as the status quo is maintained in the sales tax field, it will continue to be a drag on the country's competitiveness and to waste financial and human resources in burdensome administration and compliance.

## *Taxes on Liquor, Tobacco, and Motive Fuels*

Three co-occupied areas of consumption — alcoholic beverages, tobacco products, and motive fuels — are such significant revenue generators for federal and provincial governments alike that they deserve to be treated separately. Canada, like most industrialized countries, has taken advantage of the low short-term price elasticity of these products to keep coming back to them for more revenue. The danger for Canada, however, is that tax competition from the United States poses a threat to the tax base.

### Structure

***Liquor taxes.*** The major sources of liquor revenues for the federal government are excise taxes and duties and, for the provincial governments, liquor commission profits. The general sales taxes — the GST and the RST — also apply to these products, however, and in some provinces, the RST on liquor is set at a higher rate. There are also a number of other special charges on liquor, not to mention licenses to sell it.

The federal government, of course, collects the tariff on imported alcoholic beverages (only U.S. whiskey is tariff free), but the revenues from it are currently relatively insignificant. There is also federal excise duty on beer and spirits and a special excise tax on wine. (The supplier's price plus these federal levies equals the landed cost.) The provinces, by virtue of their control over the sale of alcoholic beverages, collect their markup ($2.3 billion in 1989) on the landed price, as well as various levies peculiar to individual provinces (see Table 11 for Quebec and Ontario levies). The federal government imposes its GST on the landed cost plus all of the markup and special levies. Some provinces, including Quebec, impose their RST on the GST-inclusive price and others, including Ontario, use the same base as the GST.[20] The Quebec and Ontario liquor tax structures, shown in Table 11, illustrate the effects of these various taxes on alcoholic beverages.

***Tobacco taxes.*** The federal government levies both excise duties and taxes on tobacco products, and all of the provinces then impose a special tobacco tax. These levies are embodied in the retailer's base price, which includes his markup. The GST is calculated on the retailer's price. Quebec and the Atlantic provinces, except Prince Edward Island, levy their RST on the GST-inclusive price. Ontario's and Manitoba's RSTs are levied on the same base as the GST. In 1992, no other provinces are imposing an RST as well as a tobacco tax. (Saskatchewan has removed its RST from tobacco.) The tax structure for a pack of 25 cigarettes in 1991 is shown in Table 12.

***Gasoline and diesel fuel taxes.*** The federal government's fuel excise tax is levied at the refinery gate. In 1991 it was 8.5 cents a liter on gasoline but only 4 cents a liter on diesel fuel. Before the introduction of the GST, there was a rebate of 1.5 cents for commercial users of gasoline, and diesel fuel was not taxed at all before 1985. For 1992 and 1993, a partial rebate of excise tax on diesel and aviation fuel is available to the transportation sector in exchange for a reduction in losses that would have been available to reduce future income taxes.

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[20] A special tax on retail purchases of alcoholic beverages is levied in Prince Edward Island, and Quebec imposes a retailer's duty on alcoholic beverages sold for resale by licensed establishments.

The provincial gasoline and diesel tax rates for 1991 are shown in Table 13. Provincial governments do not generally give preferential tax treatment for business purchases for transportation and, in most cases, they levy a higher rate on diesel fuel. Exemptions are, however, widely available for such users as farmers and fishermen and for nontransportation industrial use. (New Brunswick recently moved to rebate the aviation fuel tax on international commercial flights.)

Prince Edward Island, Nova Scotia, and British Columbia levy their gasoline taxes as a percentage of price while the remaining provinces impose it in cents per liter. The federal government's GST is added on the retail price inclusive of the provincial levy. No province included the fuel tax in its RST base until 1991, when Quebec embarked on Stage 1 of its plan to introduce its own GST.

A different type of levy — what might be called a user charge — has made its appearance in recent years, as provincial governments came to focus increasingly on issues of waste management. The Ontario government, for example, has imposed an environmental levy on nonreturnable alcoholic beverage bottles and cans for the past two or three years.

## Efficiency

*Liquor taxes.* The layers of taxes levied on alcoholic beverages by both levels of government are not harmonized at all. The result is a level of taxation on liquor in Canada that is considerably higher than in the United States, providing a strong incentive for illegal importation. In addition, not since fiscal year 1974/75 has the federal government changed the uniform flat rate levy that it collects on behalf of the provinces on travelers' imports that exceed the exemption. As

## Table 11: *The Retail Price and Tax Structure of Selected Alcoholic Beverages in Ontario and Quebec, 1991*[a]

| | U.S. Wine (1000 ml bottle) | | U.S. Whiskey (750 ml bottle) | | U.S. Beer (6 x 355 ml cans) | | Ontario Beer (6 x 355 ml cans) | Ontario Wine (1000 ml bottle, 100% Ont. grapes) |
|---|---|---|---|---|---|---|---|---|
| | Quebec | Ontario | Quebec | Ontario | Quebec | Ontario | | |
| | | | | | *(dollars)* | | | |
| Supplier's price (including freight) | 2.02 | 1.85 | 4.42 | 4.61 | 1.43 | 1.28 | 3.48 | 2.55 |
| Federal excise taxes and duties | 0.54 | 0.54 | 3.32 | 3.32 | 0.65 | 0.65 | 0.60 | 0.51 |
| Provincial markup | 4.18 | 1.49 | 10.83 | 10.97 | 2.06 | 2.33 | 1.08[b] | 0.87 |
| Additional provincial charges, Ontario | | | | | | | | |
| Wine levy | — | 1.50 | — | — | — | — | — | 1.50 |
| Bottle levy | — | 0.29 | — | 0.22 | — | 0.27 | 0.27 | 0.29 |
| Environmental fee | — | 0.04 | — | 0.04 | — | 0.27 | n.a. | 0.04 |
| Additional provincial charges, Quebec | | | | | | | | |
| Service charge and Educ-Alcool | 0.23 | — | 0.25 | — | 0.53 | — | — | — |
| Specific tax | 0.39 | — | 0.29 | — | 0.38 | — | — | — |
| *Base price* | *7.36* | *5.71* | *19.11* | *19.16* | *5.05* | *4.79* | *5.42* | *5.76* |
| Federal goods and services tax, at 7% of base price | 0.52 | 0.40 | 1.34 | 1.34 | 0.35 | 0.34 | 0.38 | 0.40 |
| *Base price for provincial retail sales tax* | *7.88* | *5.71* | *20.45* | *19.16* | *5.40* | *4.79* | *5.80* | *5.76* |
| Provincial retail sales tax[c] | 0.63 | 0.69 | 1.64 | 2.30 | 0.43 | 0.57 | 0.65 | 0.69 |
| Ontario container deposit | — | — | — | — | — | — | 0.60 | — |
| *Retail price* | *8.51* | *6.80* | *22.09* | *22.80* | *5.83* | *5.70* | *7.05* | *6.85* |

**Table 11 - continued**

| | U.S. Wine (1000 ml bottle) | | U.S. Whiskey (750 ml bottle) | | U.S. Beer (6 x 355 ml cans) | | Ontario Beer (6 x 355 ml cans) | Ontario Wine (1000 ml bottle, 100% Ont. grapes) |
|---|---|---|---|---|---|---|---|---|
| | Quebec | Ontario | Quebec | Ontario | Quebec | Ontario | | |
| | | | | *(as a percentage of supplier's price)* | | | | |
| Federal excise taxes and duties | 27 | 29 | 75 | 72 | 45 | 51 | 17 | 20 |
| Provincial markup and special levies | 238 | 180 | 257 | 244 | 208 | 225 | 39 | 106 |
| All federal levies | 52 | 51 | 105 | 101 | 70 | 77 | 28 | 36 |
| All provincial levies | 269 | 217 | 294 | 293 | 238 | 270 | 57 | 133 |

Note: Numbers may not add due to rounding.

[a] As at May 27, 1991.

[b] Beer manufacturer's fee.

[c] In Ontario, the tax is 12 percent of the base price; in Quebec, it is 8 percent of the base price plus the goods and services tax.

Sources: Based on data from the Liquor Control Board of Ontario and the Société des Alcool du Québec.

## Table 12: *The Retail Price and Tax Structure of a Pack of Cigarettes by Province, 1991*

| | Nfld. | P.E.I. | N.S. | N.B. | Que. | Ont. | Man. | Sask. | Alta. | B.C. | Canada[a] |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | *($ per pack of 25 cigarettes, as at July 1, 1991)* | | | | | | | | | | |
| Manufacturer's price plus trade markup | 1.56 | 1.56 | 1.56 | 1.56 | 1.56 | 1.56 | 1.56 | 1.56 | 1.56 | 1.56 | 1.56 |
| Federal excise tax and duty | 1.98 | 1.98 | 1.98 | 1.98 | 1.98 | 1.98 | 1.98 | 1.98 | 1.98 | 1.98 | 1.98 |
| Provincial tobacco tax | 1.70 | 2.25 | 1.70 | 2.35 | 1.44 | 1.63 | 2.00 | 1.67 | 1.75 | 2.00 | 1.67 |
| *Base price* | *5.24* | *5.79* | *5.24* | *5.89* | *4.98* | *5.17* | *5.54* | *5.21* | *5.29* | *5.54* | *5.21* |
| Federal goods and services tax, at 7% of base price | 0.37 | 0.41 | 0.37 | 0.41 | 0.35 | 0.36 | 0.39 | 0.36 | 0.37 | 0.39 | 0.37 |
| *Base price for provincial retail sales tax* | *5.61* | *6.21* | *5.61* | *6.30* | *5.33* | *5.17* | *5.54* | *5.21* | *5.67* | *5.94* | *5.80* |
| Provincial retail sales tax rate | 12% | 0% | 10% | 11% | 8% | 8% | 7% | 7% | 0% | 0% | — |
| Provincial retail sales tax | 0.67 | 0.00 | 0.56 | 0.69 | 0.43 | 0.41 | 0.39 | 0.36 | 0.00 | 0.00 | 0.33 |
| *Retail price* | *6.29* | *6.21* | *6.18* | *7.00* | *5.77* | *5.95* | *6.33* | *5.95* | *5.67* | *5.94* | *5.92* |
| Retail price as at January 1, 1992 | 6.44 | 6.35 | 6.33 | 7.16 | 6.24 | 6.10 | 6.48 | 5.72 | 5.81 | 6.45 | 6.17 |
| Taxes as % of manufacturer's price plus trade markup | | | | | | | | | | | |
| Federal | 150% | 153% | 150% | 153% | 149% | 150% | 152% | 150% | 151% | 152% | 151% |
| Provincial | 152% | 144% | 145% | 195% | 120% | 131% | 153% | 130% | 112% | 128% | 128% |

[a] Weighted average.

Source: Authors' calculations based on data from Imperial Tobacco Limited, Public Relations Department.

**Table 13:** ***Gasoline and Diesel Fuel Tax Rates by Province, 1991***

| | Gasoline | Diesel Fuel |
|---|---|---|
| | *(cents per liter)* | |
| Newfoundland | 13.7 | 15.6 |
| Prince Edward Island | 12.3 | 12.4 |
| Nova Scotia | 13.7 | 16.2 |
| New Brunswick | 12.7 | 13.7 |
| Quebec | 16.6 | 14.7 |
| Ontario | 13.0 | 12.6 |
| Manitoba | 10.5 | 10.9 |
| Saskatchewan | 10.0 | 10.0 |
| Alberta | 9.0 | 9.0 |
| British Columbia | 10.7 | 11.2 |

Note: Quebec's rates rose by 2 cents on September 1, 1991.

Source: British Columbia, Budget Address, 1991, p. 80.

provincial markups and levies grew more out of line with this rate, Canadians who crossed the border to stock up on liquor reaped substantial savings even when they traveled relatively long distances. The seriousness of crossborder shopping led the federal government to offer, in February 1992, to enter into an agreement with each province to collect a levy that is more in keeping with present-day rates.

Although there is no overall coherence in liquor levies and markups across provinces, most do keep a close watch on the final price of products in neighboring provinces, but, because sales are controlled by the governments and each has a monopoly over purchases by its own residents, there is an immunity to base erosion from out-of-province shopping. Nevertheless, the technical illegality of transporting alcohol across borders is not likely to prevent all cross-provincial-border shopping. Evidence of such interprovincial competition can be seen in the final prices of U.S. whiskey and beer in Quebec and Ontario as shown in Table 11. The varieties and brands available in each province are likely to be virtually identical. Thus, in spite of very different tax structures, the difference between final prices in the two provinces is less than 5 percent. In the case of U.S. wine, however, where the inventory can be more easily differentiated, the final price of items with a similar supplier price is much higher in Quebec by virtue of the much larger markup.

It is also apparent from Table 11 that Ontario uses differential markups to keep the prices of Ontario products in line with those of competing imports from the United States. For example, an Ontario wine that has a higher supplier price than a U.S. wine ends up with a final price almost identical to that of the import. In the case of beer, however, a fee for beer manufacturers that is lower than the markup on U.S. beer still leaves the latter at a higher final price.

***Tobacco taxes.*** The heavy taxation of tobacco products, combined with the relative ease with which they can be smuggled, has made tobacco taxation particularly vulnerable to base erosion. The cost, in terms of revenue lost by Canadian governments and retailers, spurred Ottawa to make a multipronged attack on the problem in February 1992. At the same time, it offered to begin collecting provincial tobacco taxes at the border — but not necessarily the RST, as discussed above. The failure of customs officials to collect provincial taxes at border points has added to the provinces' revenue woes, not just directly but also indirectly through the loss of retail sales.

For most provinces, the risk of lost revenue from competition with other provinces has been less than the risk of lost revenue from competition with the United States. Even when taxes in neighboring provinces are lower, distances may be too great to take advantage of the saving. The greater differentials with U.S. state taxes, however, frequently justify driving long distances, especially when purchases also include alcohol and a tankful of gasoline. (For example, Winnipeggers regularly travel to Grand Forks, North Dakota, for this purpose.)

Most provinces show a great deal of sensitivity to the risk of losing sales to neighboring provinces when they determine their tax rates. In addition, given the ease of shipping tobacco products across the country, the competition from not-so-neighboring provinces must also be taken into account.[21] As can be seen from Table 12, the retail prices of a pack of 25 cigarettes in Newfoundland, Prince Edward Island, and Nova Scotia are very close. Saskatchewan's tax change moved its retail price on cigarettes closer to Alberta's in 1992. There are, however, some notable exceptions to this competition. New Brunswick's retail price is far higher than that of any of its neighbors, and British Columbia, which already had a tax disadvantage in comparison with Alberta in 1991, widened the gap in 1992.

***Gasoline and diesel fuel taxes.*** The combined federal and provincial excise and sales taxes on gasoline are a cause of lost retail and government revenues from foreign purchases made by Canadians who live near the U.S. border. With regard to the business sector, the taxation of diesel fuel by the federal government after the mid-1980s, in addition to heavy levies in the provinces, has increased the production costs of goods and services that are transportation intensive. And since these levies are higher than the comparable levies in the United States, they can have a negative impact on Canada's international competitiveness. The federal government's temporary rebate program only partly addresses the problem because it is only available to businesses with at least 50 percent of their gross revenue from transportation activity, and is only beneficial to companies that expect to have losses for income tax purposes for quite some time.

Differences in provincial taxes affect interprovincial competitiveness. The sensitivity of some provinces to differences between their fuel tax rates and those of neighboring regions can lead to increases or decreases in those rates. Having introduced two consecutive gasoline tax rate increases in 1990, the Minister of Finance for Nova Scotia stated: "After the tax increases I have outlined, Nova Scotia's taxes are comparable with other provinces in the Atlantic region."[22] Whenever the differentials have caused a serious erosion in tax revenue, however, provinces have moved either to reduce the overall gap or to make selective reductions in vulnerable regions. The most highly publicized example of the latter was Quebec's selective reductions in peripheral and designated zones, beginning in the mid-1980s. Since 1984, Newfoundland has also reduced rates in its Labrador-Quebec border area. Nevertheless, differences in rates remain substantial in many cases.

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[21] This interprovincial sensitivity can work both ways, as the move by the B.C. government in 1991 to increase the tobacco tax rate shows. The finance minister noted that British Columbia's rate was the lowest of any province and that, after a proposed increase, it would be closer to the Canadian average (British Columbia, Budget Address, 1991, p. 15).

## Simplicity

From the point of view of administrative and compliance costs, excise taxes such as those described above give the best value. As Sandford and colleagues conclude,

> even if the compliance costs have been significantly underestimated, it could still be true that an outstanding merit of excise duties in comparison to broad-based taxes on income or consumption is that their direct costs of operation are lower, both in relative and in absolute terms.[23]

The joint but unharmonized occupancy of the excise tax field by two levels of government, which tend to have more than one type of tax for each commodity, means that the overall structure of taxation of alcohol, tobacco, and gasoline is far from simple and, therefore, may be relatively costly to operate.

## Accountability

The layers of taxes on fuel and tobacco products and the assortment of taxes, levies, and markups currently imposed on alcohol are such that it is unlikely that purchasers could be aware of the amount of tax they are paying, let alone to which level of government.

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[22] Nova Scotia, Budget Address, 1990, p. 7.

[23] Sandford, Godwin, and Hardwick, *Administrative and Compliance Costs*, p. 169.

Some of the excise taxes and levies can rationally be linked to specific spending functions. For example, provincial revenues from gasoline and diesel fuel, drivers' licenses, and motor vehicle permits were originally intended to pay for the costs of road construction and, although that statutory link no longer exists, there is considerable evidence to suggest that both the public and the provincial governments see these revenue sources as types of user charges.[24] An illustration of the sort of action provinces might take to consolidate such a perception is the establishment by Nova Scotia in 1990 of a special Transportation Trust Fund. By 1991, 2 cents per liter of the gasoline tax and 4.5 cents per liter of the diesel oil tax was being channeled to this fund for the construction and upgrading of the province's 100 Series highways. In 1990, British Columbia established a Freedom to Move Special Account for the funding of transportation infrastructure — although no revenues were earmarked specifically for this account. It is through such measures that provinces can help to connect taxation and expenditure in the public's mind, and thereby increase accountability.

Governments often justify increases in "sin" taxes by claiming that their objective is to discourage tobacco and alcohol use. Two provinces have gone even farther: Prince Edward Island levies its tobacco and alcoholic beverage tax under the *Health Tax Act*, and Nova Scotia levies its tobacco tax under the *Health Services Act*. Though the link between sin taxes and health care is not as direct as the one between fuel taxes and road construction, there is still a strong case for earmarking such revenues. Thus far, no obvious connection exists in practice (or in the public's mind) between the federal government's revenues from alcohol and tobacco and its transfers to the provinces under the Established Program Financing arrangement for health, which raises the question of whether such taxes are appropriate at the federal level.

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[24] Robinson, *Retail Sales Tax*, pp. 20–21.

## Equity

Excise taxes appear, for the most part, to be passed on to consumers and, as a broad-based tax, to be proportional to lifetime consumption. Tax rates across the country do differ, so consumers in similar financial circumstances who consume similar quantities of the taxed commodities are in fact being taxed differently. These differences may be justified when the taxes are earmarked for specific expenditures. In other words, different preferences for government programs by taxpayers in different provinces may require different levels of tax revenue. When the taxes are levied for reasons other than to finance specific expenditures, however, the large interprovincial differences may violate the principle of equity. For example, two reasons that are often cited for taxing tobacco products more heavily than other goods are (1) to create a disincentive to smoking and (2) to offset the economic costs to society of this habit.[25] It is highly unlikely that either the price elasticity of demand for tobacco products or the costs of smoking in terms of health and property damage vary as much as the range in provincial rates (for example, from 112 percent to 195 percent in 1991) would suggest. On equity grounds, therefore, national standards for tobacco excise tax rates may be desirable.

## Recommendations

Accountability would be improved if all revenues from motive fuels and associated licenses were officially earmarked for road construction and maintenance, and the appropriate corresponding accounting made evident in both budgets and public accounts. Since the lion's share of expenditures on roads is borne by provincial and municipal governments, it would be logical to assign the motive fuel tax field to the provinces. The case is less clear for the allocation of the tax on aviation fuel: these revenues might be better left with the federal government to pay for research on environmental issues or for other related responsibilities.

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[25] See "Tobacco Taxation: An Exercise in Obfuscation," *The Canadian Taxpayer*, July 30, 1991, p. 118, for a discussion of the costs to society of smoking compared with the tax revenues from tobacco products.

Similarly, excise duties and taxes on tobacco products and liquor should be allocated to the government responsible for health care. A deliberate link between these taxes and the appropriate spending function would allow taxpayers to see the connection between spending and taxation, which is currently too tenuous.[26]

Although there are equity arguments for similar rates of tobacco taxation across the country, as discussed, there are stronger efficiency arguments for allocating these excise taxes to the provincial governments — one being the provinces' need to keep rates competitive with those of adjacent U.S. states. A transfer of federal taxing power over alcohol could require, however, that the provinces simplify the structure of their levies. Finally, there would be a gain for the national economy in eliminating the excess administrative and compliance costs associated with the levying of excise taxes by two levels of government.

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[26] Quebec is still directing part of its tobacco tax revenues to financing its 1976 Olympic deficit, the connection presumably being that sports lead to good health.

# Chapter 9

# *Other Taxes*

## *Real Property Taxes*

As in many other countries, local governments in Canada raise much of the revenue needed to support local services and to contribute to the support of the welfare system and elementary and secondary education. Two main sources of revenue are available to local authorities: the property tax, which is levied on the owners of real property (both land and buildings), and the business tax, which is levied on the business occupant (owner or tenant).1

### Structure

The real property tax is far more important, in terms of revenue raised, than the business tax, representing roughly 89 percent of the two taxes combined for Canada as a whole. (Three provinces do not have a business tax at all.) There are considerable variations in the role of the property tax by province. In five provinces, it is virtually confined to local governments. Prince Edward Island, New Brunswick, Manitoba, Alberta, and British Columbia co-occupy the property tax field with their municipal governments for the purpose of financing education.

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[1] For a description of local government revenue sources, see Harry M. Kitchen, *Property Taxation in Canada* (Toronto: Canadian Tax Foundation, 1992, pp. 9–14, and pp. 16–17 for an international comparison of local government taxes. Much of this section draws on this study and on Harry M. Kitchen, *Local Government Finance in Canada* (Toronto: Canadian Tax Foundation, 1984).

What is more important with regard to the question of the division of taxation powers is the fact that, in a province such as Newfoundland, the real property tax is relatively unimportant because of the rural nature of the province, which means that the financing not only of all education but also of fire and police protection comes from provincial government revenue sources. More recently, other provinces have increased the general provincial taxation share of education funding and reduced the share borne by the local residential property tax.[2]

## Simplicity

One important advantage of the real property tax is that it is easy to understand and relatively simple to operate. The Sandford study of the administrative and compliance costs of property taxes in the United Kingdom concluded, for example, that those costs were considerably lower than the analogous costs for the income and sales taxes but higher than those associated with excise taxes. The advantage was attributable almost entirely to the low compliance costs.[3]

## Efficiency

Industrial property appears to be more heavily taxed than residential property,[4] although there is some evidence to suggest that the business sector receives fewer benefits from local governments than does the residential sector.[5] The variation in these taxes from province to province — not to mention from municipality to municipality — may be sufficient to influence the location of a business. To the extent that such taxation makes the overall burden on business more onerous in Canada than in the United States, it has an adverse impact on international mobility. Since provinces are likely to be more sensitive to issues of competitiveness and have access to more tax fields, one solution may be for municipalities to have control over the residential school levy and for the provincial government to have control over the industrial portion of the property tax and greater responsibility for financing education. Local services that primarily benefit private citizens would be completely covered by the residential property tax, and the services that benefit the industrial and commercial sectors would be covered by a user charge on business. (To prevent hardship to low-income groups, there could be greater reliance on property tax credits granted by provincial governments.) Provinces would have the freedom to replace the business property tax with a nondistorting revenue source. Having control over the business portion of the property tax enabled the British Columbia government to increase the competitiveness of its business sector and to encourage investment by reducing this burden.[6]

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[2] For example, in 1990, British Columbia restructured its funding of public education switching to block funding financed out of the provincial residential school property tax. School boards that exceed this provincial allocation may hold a referendum to obtain local taxpayer approval for a supplementary local residential property tax levy (British Columbia, Budget Address, 1990, pp. 57–61).

[3] Cedric Sandford, Michael Godwin, and Peter Hardwick, *Administrative and Compliance Costs of Taxation* (Bath: Fiscal Publications, 1989), p. 192.

[4] Kitchen, *Property Taxation*, pp. 14–15.

[5] Frank A. Clayton, "An Assessment of Proposals Affecting Property Tax Burdens," in *Report of Proceedings of the Special Tax Conference*, January 12–13, 1968 (Toronto: Canadian Tax Foundation, 1968), pp. 47–64; cited in Kitchen, *Local Government Finance*, p. 212.

## Miscellaneous Taxes

There are a number of taxes and charges that are dominated or solely occupied by the provincial governments. Not all of these taxes are levied by all the provinces, and a few of them have had a limited life — for example, Saskatchewan's gambling tax. Nevertheless, we conclude that a "keeping up with the Jones's" syndrome does attach to such taxes, since the trend among provincial governments has been to expand rather than decrease, their arsenals of them. One might therefore predict that, in time, almost all of these taxes will indeed be levied by all provinces.

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[6] British Columbia, Budget Address, 1986, p. 17.

Some of the older levies are related to land use:

- Land transfer taxes are imposed at the provincial-local level only. In New Brunswick, Ontario, Manitoba, and British Columbia (with its property purchase tax), they are levied by the provincial government, and in Nova Scotia and Quebec by municipal governments.
- Land speculation taxes currently exist only in Quebec, although Ontario levied one briefly in the 1970s.

Since 1969, all the provinces have become involved in the operation of lotteries, although only Ontario and Quebec run their own. The Western Lottery Foundation is owned by the four Western provinces and the Atlantic Lottery Corporation by the four Atlantic provinces. The federal government also occupied this field from September 1976 to December 1979, but its ambitions to continue to share it were thwarted by a remarkable show of solidarity by the provinces.[7]

All of the provinces levy taxes or charges on insurance premiums.

A number of minor taxes are levied at the provincial-local level primarily to influence economic decisions. These have multiplied in recent years, with the provinces' attempts to address environmental problems and similar concerns. Examples include the taxes on new tires and new batteries, Ontario's gas guzzler tax, and the corporate concentration tax. Unfortunate- ly, these levies are rarely earmarked for related programs. In Ontario, revenues from such taxes are only notionally earmarked for environmental purposes. Manitoba introduced a levy on new tires (its Environment Protection Tax) in 1989 and later established an Environmental Innovations Fund. British Columbia has earmarked revenues from various taxes and charges that are designed to discourage pollution for its Sustainable Environment Fund, which will support environmental initiatives and reforestation. Some of the revenue sources involved are the taxes on new tires and batteries — the revenues are to be used for recycling and disposal initiatives.[8] Unfortunately, the province's budget statement does not include a statement of the account, showing the revenue raised from the earmarked levies and how it was spent, although the expenditures of the fund are detailed in the text. To enhance accountability, these funds need a higher profile in the provincial budgets and, in the case of Manitoba, its expenditure must be linked more overtly to the revenues from the levies.

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[7] During the federal government's brief occupancy of the lottery field, the provinces also managed to restrict its involvement to the "upscale" market by insisting that its tickets be priced at $10 or more, while provincial tickets were to be sold at $9 or less.

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[8] British Columbia, Budget Address, 1990, pp. 80–81. The revenues from the retail sales tax on disposable diapers will also be part of the fund and will be spent on solid-waste management.

# Chapter 10

## *Recommendations*

In its discussion paper on the personal income tax (PIT), the federal government suggested that access to a variety of tax sources by both the federal and the provincial governments was an important way to reduce volatility in total revenue.[1] On the surface, such an objective seems vital, but it does not stand up to closer scrutiny. What the federal government appears to be arguing for is immunity of government revenues to business cycles. This line of reasoning leads to such misguided actions as the discretionary increase in the unemployment insurance (UI) premium rate in mid-1991, when the economy was still trying to heave itself out of recession, and the growing use of capital taxes on corporations. In fact, the more revenues fluctuate with business cycles, the more they will serve as stabilizers of economic activity, eliminating the need to second-guess the direction in which the economy is going as well as the temptation to introduce what invariably prove to be poorly planned and badly timed discretionary stimuli. In conjunction with a strong commitment by governments — derived, perhaps, through a constitutional mandate — to balance their budgets over the business cycle, cyclically sensitive revenues would be a very valuable instrument of fiscal policy.

There is only one valid reason for giving both levels of government the power to diversify their revenue sources: to avoid total tax-base erosion. Consider, for example, that the Canadian tariff was the federal government's most important source of revenue in 1867. Revenues from this source have been declining relative to economic growth for many years, because of tariff-rate reductions under the General Agreement on Tariffs and Trade and, more recently, under the Canada-U.S. Free Trade Agreement. There is another reason for arguing that its constitutional right to access any tax field should not be disturbed, which is the federal government's "peace, order, and good government" authority under the Constitution. Thus, regardless how spending powers are allocated, the federal government will continue to be responsible for dealing with national disasters such as war, insurrections, and epidemics, and for aiding the provincial governments at times of regional crisis. In such instances, it may need to turn to international bond markets, and any limitations on its sources of taxation could affect its cost of borrowing.

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[1] Canada, Department of Finance, *Personal Income Tax Coordination: The Federal-Provincial Tax Collection Agreements*, Ottawa, June 1991, p. 4.

The right to access all taxation fields does not mean that the federal government should be entirely free from constraints in its revenue-raising activities. Such constraints, however, should be implemented by means of binding agreements between the federal and the provincial governments, rather than through entrenchment in the Constitution — an option that would deprive the tax system of its ability to be adapted to changing circumstances. These federal-provincial agreements should perhaps be binding for no more than five years, in the event that changes in spending pressures or obligations render the existing allocation of taxing powers obsolete.

If one accepts that equity has a strong regional dimension and that neither level of government needs to make use of most taxation sources, taxing powers can be distributed more efficiently without violating the need for a reasonable amount of flexibility, while markedly improving accountability and transparency. At the same time, it is also possible to take into account some hypothetical changes in spending responsibilities, which might be part of a devolution to the provinces. Of the various changes in responsibility — for both jointly and federally financed programs — that have recently been proposed or discussed by governments and economists,[2] we examine the following:

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[2] See, for example, John Richards, "Suggestions on Getting the Constitutional Division of Powers Right," and Jean-Michel Cousineau, "Social Security and the Division of Powers in Canada," both in Jean-Michel Cousineau, Claude E. Forget...

- The elimination of federal financing of health care and post-secondary education (Established Programs Financing — EPF) and of social services (Canada Assistance Program — CAP);
- the federal government's recognition of exclusive provincial jurisdiction over housing, which we interpret as provincial governments' taking up federal spending in this area;
- the implications of the transfer of UI operations and financing to the provinces.

In order to assess the feasibility of financing these rearrangements, we used Statistics Canada's *Provincial Economic Accounts* for 1989 as a basis for estimating possible outcomes.[3] The results, summarized below, are shown in Table 14.

- The provinces give up their taxes on corporate income and capital, and the federal government increases its corporate income tax rates to raise an equivalent amount of revenue.
- The federal government gives up to the provinces its excise taxes and duties on alcohol, tobacco, and gasoline, as well as minor excise taxes, such as the tax on jewelry.
- The federal government transfers its goods and services tax (GST) room to the provinces.

The net transfer of tax room to the provinces would result in an automatic adjustment to the equalization payments.

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*Note 2 - cont'd.*

...and John Richards, *Delivering the Goods: The Federal-Provincial Division of Spending Powers*, The Canada Round 12 (Toronto: C.D. Howe Institute, 1992); and Canada, *Proposals for the Economic Union* (Ottawa, 1991).

[3] The federal excise taxes were re-estimated according to provincial consumption patterns in order to replace the allocation according to the way the federal government collects this revenue. The federal sales tax that was still collected in 1989 was replaced by an estimate of the goods and services tax that could have been collected by each province. All of these estimates are, of course, very rough.

## Table 14: *Reallocation of Spending and Taxes by Province, 1989 Estimates*

| | Nfld. | P.E.I. | N.S. | N.B. | Que. | Ont. | Man. | Sask. | Alta. | B.C. | Federal |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | *($ millions)* | | | | | |
| Provincial corporate income tax and capital tax | -65 | -17 | -123 | -113 | -1,424 | -3,390 | -291 | -222 | -898 | -556 | 7,115 |
| Federal excise taxes | 133 | 30 | 182 | 158 | 1,396 | 2,620 | 259 | 242 | 730 | 837 | -6,624 |
| Net | 68 | 13 | 59 | 45 | -28 | -770 | -32 | 20 | 168 | 281 | 491 |
| Canada Assistance Plan transfers[a] | -97 | -23 | -154 | -155 | -1,658 | -1,675 | -193 | -151 | -500 | -677 | 5,341 |
| Established Programs Financing transfers[b] | -219 | -50 | -343 | -278 | -2,516 | -3,056 | -421 | -404 | -1,008 | -1,241 | 9,566 |
| Federal goods and services tax | 294 | 69 | 505 | 402 | 4,236 | 7,370 | 591 | 526 | 1,587 | 2,107 | -17,738 |
| Equalization | 18 | 4 | 30 | 24 | 254 | 0 | 35 | 32 | 0 | 0 | -397 |
| Net | -4 | 0 | 38 | 24 | 316 | 2,639 | 12 | -3 | 79 | 189 | -3,228 |
| Federal housing expenditure | -32 | -7 | -50 | -7 | -375 | -537 | -61 | -56 | -135 | -171 | 1,466 |
| *Total net effect* | *32* | *6* | *47* | *-2* | *-87* | *1,332* | *-49* | *-33* | *112* | *299* | *-1,473* |
| Memo item: Unemployment insurance balance | -665 | -114 | -266 | -397 | -1,211 | -1,812 | -4 | -34 | 70 | -337 | 1,132 |

[a] Includes Quebec tax abatement of $560.

[b] Includes Quebec tax abatement of $882.21.

Sources: Authors' calculations based on data from Statistics Canada, *Provincial Economic Accounts* for 1989, and unpublished data from Statistics Canada and Canada, Department of Finance.

As we suggested earlier, the arguments for the allocation of both the corporate and capital taxes to the federal government are far weightier than those that advocate co-occupancy. The loss of these revenue sources by the provinces could be offset by their acquisition of the fuel, tobacco, and alcohol taxation fields. The assignment of all excise taxes and duties to the provinces should be accompanied by a simplification of provincial liquor taxation. These corporate and tax "exchanges" would leave the federal government slightly better off. Ontario is the major loser. There is also some geographical redistribution, notably benefiting Alberta and British Columbia. There would be significant overall savings in administrative costs.

The transfer of the federal government's GST room would have to be done on a province-by-province basis, as the provinces implemented the necessary reforms of their retail sales taxes — to eliminate tax on business inputs and to broaden the base to at least the extent of the GST. The outcome would be an enormous saving in administrative and compliance costs. Furthermore, the federal government would then collect the tax for all the provinces at Canadian border crossings. It should be noted that all provinces would not necessarily take up exactly the same sales tax room. Some provinces (for example, Alberta) might wish to raise their PIT rather than to use the sales tax.

If a province has suffered a significant loss of retail sales to the United States, a rational response to the extra excise and sales tax room would be to replace it with an increase in a tax on a less-mobile base — say, on personal income.

The loss of GST room by the federal government would have to be compensated by the transfer of some PIT points to, or the devolution of some spending responsibilities from, the federal government. If the federal government were to phase out all transfers under the EPF and CAP programs, the federal loss would be reduced (to $2 billion in the 1989 example). In this exchange, the "have" provinces are big winners. Six "have-not" provinces would gain under the present equalization formula from the transfer of the GST to the provinces. Quebec would be a moderate loser.

Finally, the transfer of the federal government's housing function to the provinces combined with the above exchanges would leave Ottawa short to the tune of $1.5 billion in the 1989 exercise. Regionally, there is a break-even situation for the Atlantic provinces and Saskatchewan. Quebec and Manitoba are net losers at about the same per capita level, while Ontario, Alberta, and British Columbia are net gainers at a fairly similar per capita rate. Thus, there would have to be an adjustment in revenues in favor of the federal government, paid for by the "have" provinces. This could be achieved by means of an adjustment in the PIT and equalization or retraining funds, or a combination of these measures.

The suggested redistribution of taxing powers would produce a simpler and more efficient tax system, which would yield major savings to the economy in operation costs. At the same time, it would achieve further economic gains for the whole country by reducing the number of tax sources. Thus, those provinces that have general payroll taxes would be asked to replace them with an increase in the PIT. The federal government would, in return, remove the capital taxes.

If the federal government surrendered all of its involvement in manpower training, it might return the responsibility for UI to the provinces. The balances between premium revenue and benefits by province in 1989 (see Table 14) are representative of a nonrecessionary year, during which the UI program acts as a vehicle for a massive transfer from Ontario to Quebec and the Atlantic provinces. Devolution to the provinces' jurisdiction could, therefore, lead to lower premiums for the Ontario work force without any loss of benefits, while the five Eastern provinces would have to raise premiums or make qualifications for UI benefits more stringent, since the addition of UI premium revenue to the equalization calculation as it is currently devised would not result in a sufficiently large offset.

It is clear that it would be impossible to propose such massive disruptions to the present system without acknowledging that the equalization program would need to undergo a serious renewal. This question, however, must be left to other writers.

## Conclusion

When Canadians began, in 1990, to grapple with such gut-wrenching issues as distinct societies, aboriginal self-government, and the protection of social programs, it may have seemed almost trivial to ask whether or not the country's tax structure was as efficient and fair as it could be. Indeed, as more and more studies and discussion papers originated from both the private and the public sectors, it often seemed that the question of how the revenues were raised in order to deliver all the programs that the country holds dear had been forgotten. Nevertheless, the link between a caring and just society and its economic health has surfaced more recently in the round of studies on competitiveness and prosperity. The ability of the tax structure to influence economic decisions, and the deadweight loss to the economy from the way revenues are raised — not to mention the problem of leakages of economic activity out of the country or into the underground economy — are matters too important to be left out of the constitutional debates.

In the detailed examination of the federal-provincial fabric of the Canadian tax structure that we have undertaken in this book, we have attempted to pull together the most important issues to be considered. We have also tried to add some new insights into the ways in which this country might move toward a more workable division of taxing powers and, indeed, toward an optimal tax system. In recommending such apparently radical exchanges of powers as entrusting the taxation of corporate capital and income solely to the federal government while placing consumption taxes exclusively in the hands of the provincial governments, we have also suggested that the bargaining process by which these changes would be achieved should include the elimination of those taxes that impose an excessive burden on the economy relative to the revenues they generate.

In particular, the rationalization of the tax system along the lines that we have suggested would help to strengthen the economic union by minimizing opportunities for the erection of interprovincial barriers to the mobility of goods, services, labor, and capital. It would also provide a greater stimulus to rid the system of the most damaging differentials with the United States, thus enhancing our international competitiveness. Other important benefits would include the reduction in overall administrative costs, which would help in deficit reduction, and in compliance costs, which would further increase the overall efficiency of the economy. Finally, there would be an increase in accountability and transparency, which are important elements in a well-functioning democracy.

# A Comment

## Claude E. Forget

The most important recommendations that emerge from the study by Irene Ip and Jack Mintz are those directed toward the concentration of: (i) corporate income taxation at the federal level; and (ii) all consumption taxation at the provincial level. Ip and Mintz make it clear that such a reallocation of taxing authority would involve the re-examination of the formula used for making equalization payments to the provinces. The redistributional implications of such recommendations are considerable, but it would be difficult to criticize the authors on those grounds unless changing the equalization formula were demonstrably infeasible.

Considering the history of judicial interpretation of the constitutional provisions on taxing powers — provisions to the effect that the federal government may levy any kind of tax whereas the provinces are restricted to levying direct taxes — and considering that those restrictions have not prevented the provinces from levying retail sales taxes, one can easily question the effectiveness or even the usefulness of drawing the line in some other way. However, the authors' recommendations would still be of interest even if the Constitution were to allow both levels of government to levy any kind of tax — except, of course, custom duties, which would remain the domain of the federal government, and real property taxes, which would fall under provincial jurisdiction.

Perhaps more important than rules concerning the allocation of taxing powers would be constitutional provisions on the liability of enterprises controlled by one level of government to pay taxes levied by another level of government. Because of an interpretation given to Crown privilege, government enterprises in Canada traditionally have been exempt from corporate taxation. This has had a distorting influence on industrial organization and has created a bias in favor of public enterprises. Nothing short of a constitutional provision can now settle this issue once and for all. Some limited but binding tax harmonization requirements might also be inserted in the Constitution to simplify taxpayer compliance. An example is a rule requiring all governments using the personal income tax base to follow the same concept of taxable income. The Constitution would, of course, then have to prescribe a mechanism to make that determination.

A similar issue arises with regard to the deductibility of taxes paid to one level of government in computing tax liability toward another level of government. Numerous examples exist of manipulative behavior by governments in this regard that have resulted in considerable instability in the fiscal situation confronting taxpayers, so an attempt to resolve this issue in the Constitution would be worthwhile.

It is particularly in a discussion of the division of taxing powers that the inherently conservative bias of any constitutional debate is manifest. While the imaginative proposals of Ip and Mintz would simplify taxpayers' lives considerably, it would also require significant changes to the way in which "the system" works. I would venture to suggest that since only bureaucrats seem to understand fully the complicated world in which we live, their concurrence — or at least cooperation — would be essential. Yet, knowing that dramatic changes to "the system" would jeopardize their power and even careers, it is only natural to expect bureaucrats to put up a tremendous resistance to such changes.

Ip and Mintz target excessive administrative costs and impediments to capital mobility. But bureaucrats are experts at arguing against the seriousness of such problems by pointing to the many detailed rules of implementation that, in practice, serve to minimize them. For example, the incentives inherent in the differential provincial taxation of corporate profits have largely been counteracted by rules that allocate corporate profits among the provinces so as to make the tax base relatively impervious to manipulation by taxpayers. Similarly, bureaucrats traditionally have argued in favor of the existing practice of levying excise duties and taxes federally by citing the ease with which such taxes can be collected from the relatively few distillers, brewers, cigarettemakers, and oil refiners, rather than having to collect them at thousands of retail sales outlets.

Since a clever bureaucracy can adapt to almost any situation, it is doubtful whether, at the end of the day, any arguments in favor of economic efficiency could survive with sufficient strength to motivate dramatic changes — bureaucrats can easily throw the constitutional baby out with the bathwater.

# The Contributors

*Claude E. Forget* has had a career spanning academia, provincial public administration and politics, and the private sector. He came to social policymaking from the perspective of economics and, in the 1970s, was responsible for devising and/or implementing several of the financial and organizational features of health and social services in Quebec concomitant with the introduction of medicare. In that role and later, at the time of the 1980 Quebec referendum, he was extensively involved in federal-provincial and constitutional affairs. In 1985–86, he chaired the federal Commission of Inquiry on Unemployment Insurance.

*Irene K. Ip* is a Senior Policy Analyst at the C.D. Howe Institute and Advisor to the C.D. Howe Institute Policy Analysis Committee. Before joining the Institute, she was a Vice-President and Chief Forecaster at investment dealer Wood Gundy Inc. Ms. Ip has written extensively on Canadian public finance. Among her recent publications are *Big Spenders: A Survey of Provincial Government Finances in Canada* (1991); and *Strong Medicine: Budgeting for Recession and Recovery* (1991).

*Jack M. Mintz* is the Arthur Andersen Professor of Taxation, Faculty of Management, University of Toronto. He has published more than 70 books and articles in the field of public finance and fiscal federalism. He was a Special Advisor to the Assistant Deputy Minister, Tax Policy Branch, Finance Canada from 1984 to 1986, and Director of the John Deutsch Institute for the Study of Economic Policy at Queen's University from 1987 to 1989. He has also served as a consultant to numerous governments, international organizations, and companies.

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*Irene K. Ip* is a Senior Policy Analyst at the C.D. Howe Institute. Her most recent publication is *Big Spenders; A Survey of Provincial Government Finances in Canada* (1991).

*Jack M. Mintz* is the Arthur Andersen Professor of Taxation in the Faculty of Management at the University of Toronto. He has published more than 70 books and articles in the field of public finance and fiscal federalism, and has served as a consultant to numerous governments, international organizations, and companies.

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